Canada Mortgage and Housing Corporation

Société canadienne d'hypothèques et de logement

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THE TREATMENT OF RESIDENTIAL HOUSING UNDER A MULTI-STAGE SALES TAX: ALTERNATIVES TO THE JUNE 1987 WHITE PAPER FEDERAL SALES TAX REFORM PROPOSALS

The Treatment of Residential Housing Under a Multi-Stage Sales Tax:

Alternatives to the June 1987 White Paper Federal Sales Tax Reform Proposals

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Abstract

The June 1987 White Paper Federal Sales Tax Reform Proposals will significantly increase the sales tax on new housing relative to the current treatment under the Manufacturer's Sales Tax (MST) and relative to commodities which are presently fully taxed under the MST. The increase occurs because only building materials are taxed under the MST and at a preferential rate whereas under the Proposals the entire value of a new house including the land, development costs, construction costs, and the realtor's services will be subject to the full sales tax rate. The increased tax will be partly shifted back to inputs, for example by lowering the value of undeveloped land, and partly shifted forward to consumers by an increase in the price of a new house.

In general it is presumed that a sales tax which applies equally to all goods and services consumed is more efficient and easier to administer. While such a tax may be less progressive than desired, it is thought that progressivity is better achieved through the personal income tax system, such as with a sales tax credit. The general thrust of the Proposals in bringing housing fully under the sales tax is in accordance with these views.

It is difficult to tax the services of owner-occupied housing as consumed, but taxing the the value of the house when it is constructed and sold is a close substitute. Since the purchase price "capitalizes" the value of future services, the tax on housing services is "prepaid". In this case the tax is paid up front and should not be levied again if the house is resold otherwise tax cascading results.

In order to avoid cascading, the Proposals exclude existing (old) housing from the sales tax base. This will confer a capital gain on the owners of existing houses because values will rise with the tax inclusive price of new houses. This capital gain causes a transfer in wealth to existing homeowners from potential home buyers.

Most countries that levy a multi-stage sales tax include new housing and exempt existing housing from the base. Many offer reduced tax rates or other preferences on new housing

and levy real estate transfer taxes on sales of houses that not included in the VAT. Also, most countries give preferential treatment to residential housing in the income tax system including (most commonly) the exemption of a principal residence from capital gains taxes and deductions or credits for some costs of owner occupied housing.

There exist four main alternatives to the White Paper Proposals. One is to treat residential housing as a tax free supply as in the U.K., but there are no good economic arguments for this option. The second is to apply the tax to the structure only and not to the land as is done in several European countries. This poses administrative difficulties and has no economic rational. The third is to duplicate the status quo by taxing building materials only. The advantage of this alternative is that it leaves the housing market as is and avoids the transition difficulties in this market. The fourth is to include new housing and the first sale of existing housing in the base. This alternative achieves the objectives described in the White Paper but avoids the negative feature of transfering wealth from the housing have-nots to the housing haves. Finally, if housing is included in the tax base on a prepaid basis as proposed, the liquidity difficulties associated with the large "up front" tax payment can be mitigated by a special treatment of mortgage finance under the sales tax.

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I. Introduction

All the major tax bases touch upon housing in one way or another. An evaluation of the tax treatment of housing under the sales tax reform cannot be made in isolation of its treatment under the system of direct personal and corporate taxes. This introductory section sets the stage for an overall evaluation of the tax treatment of housing by setting out the fundamental principles of tax design and tax reform, and reviewing the major implications of them as they apply to the three major tax sources of the federal and provincial governments- personal income, corporate income, and sales taxes. The specific manner in which these principles apply to housing will then be discussed in the second section. With this conceptual background in hand, we will then be in a position to evaluate the proposed treatment of housing under the federal sales tax reform and to consider the appropriate alternatives.

It should be noted that property taxes also impinge upon housing directly and form the major source of revenues for local governments. A full consideration of property taxes would take us too far afield, although in principle it would be useful to take them into account. Where they seem most relevant for our analysis, we will allude to them briefly.

i. Principles of tax design

It is generally agreed by tax specialists and practitioners alike that there are three major criteria for judging taxes. These are efficiency, equity and administrative simplicity. Chapter 1 of the Department of Finance White Paper of June 18, 1987 entitled Tax Reform 1987: Sales Tax Reform, hereafter referred to as the "White Paper", is devoted entirely to expounding these principles as they apply to sales tax reform. For our purposes, the briefest of surveys will suffice.

The term efficiency refers to the extent to which the market economy is able to exploit all mutually beneficial gains from trade between the demand and supply sides of markets in the economy. A fully efficient economy is one in which all such gains are exploited, and it would be achieved by the unfettered functioning of a competitive market mechanism. An efficient tax system is one which interferes least with (i.e., imposes least distortion on) the operation of markets. This is what the White Paper refers to as a neutral tax system. Unfortunately, no tax is perfectly neutral. Virtually all realistic taxes impose some distortions on the operation of some markets. Thus, in comparing one tax with another, or evaluating the reform of one particular tax, one must identify the magnitude of the distortions or inefficiency imposed by each and judge which option is the least distortionary. At this stage of development of economic knowledge, this judgment can only be made imperfectly. In general, it seems that broad-based taxes with relatively low rates are least distorting. As well, among broad-based taxes, those applying on bases with less elastic demands and supplies are less distorting.

In evaluating the distorting effects of a particular tax, it is important to recognize that this cannot be done in isolation. For one thing, to the extent that different taxes apply to the same base, the distorting effect of each is compounded. For example, the personal income tax and the general sales tax both apply to the use of labour income to acquire consumption goods. Therefore, when evaluating the efficiency effects of the sales tax on labour market distortions, the existence of the income tax must be taken into account. The sales tax adds to a tax rate on labour income that is already in effect. This cascading is important since the efficiency loss of a tax increases roughly with the square of the tax rate. On the other hand, the introduction of a tax may serve to offset a distortion elsewhere in the tax system. In this case, the combination of two taxes in the system could be less distorting than either

taken alone. For example, it is well-known that the personal tax system favours the holding of wealth in the form of housing rather than as equity capital or bonds. That is because the rate of return on housing is not taxed, while that on other assets is. This is partly offset in times of inflation if the tax system is not properly indexed. In this case, because the inflation component of interest (including mortgage interest) payments are taxed, nominal interest rates will generally rise by more than the rate of inflation. This means that real mortgage rates increase with inflation and therefore the cost of financing a house will rise assuming mortgage interest is not tax deductible. A new tax which does tax housing more relative to other assets may reduce the distortionary effect of the tax system as a whole. In making these comparisons, it is also important to know the revenue implications of the tax reform. It is often simpler to separate the effects of raising additional revenue from pure changes in the tax structure used to raise a given amount of revenue. We will generally be concerned with evaluating tax system changes that are "revenue-neutral".

The second general principle of a good tax system is equity, or what the White Paper refers to as fairness. There are two aspects to equity. One is that persons in like circumstances ought to be treated in a like manner by the tax system. This is so-called horizontal equity. The other is that the system ought to be appropriately progressive. That is, it ought to be vertically equitable. These concepts of equity are difficult to apply, requiring as they do some value judgments. The best that an economist can do is to take as given the equity norms that policymakers appear to have in mind and evaluate the tax system accordingly. In doing so, it is again important to take into account the tax system as a whole when evaluating a particular tax. It is also important to recognize that a given degree of vertical equity can be achieved in a number of equivalent ways. For example, virtually the same effect of a system of credits designed to assist lower income taxpayers can be achieved with a set of exemptions and an appropriately changed rate structure.

The goals of efficiency and equity cannot themselves be considered in isolation since they are to some extent conflicting. More redistributive equity can only be achieved by making the tax system more progressive. Doing so inevitably increases overall marginal tax rates and thereby increases the distorting effects of the tax system.

The third criterion of tax design is the ease of administration. There are several dimensions to this. Any tax system will involve collection and enforcement costs borne by the government. The more complicated the tax system, the higher will these be. The Canadian tax system is largely based on the self-assessment principle, which economizes greatly on collection costs. At the same time, it imposes on the private sector costs of complying with the tax. Again, the simpler the tax system, the lower will be these compliance costs. As well, collection and compliance will be less costly the more they rely on observable data, such as actual market transactions, for their operation.

Let us now turn briefly to how these principles apply in the broad to the major tax bases of the federal and provincial governments.

ii. Personal taxation

The main issue in personal tax system design is the choice of a base. It was the focus of the Report of the Royal Commission on Taxation of 1967 (the Carter Report), as well as of a series of subsequent tax reform documents in various countries, including, for example, The U.S. Treasury's Blueprints for Basic Tax Reform (1977), the Meade Report in the U.K. (1978), the Report of the Macdonald Royal Commission in Canada (1984) and the recent report of the Economic Council of Canada entitled Roadmap to Tax Reform. While the Carter Report took the view that the ideal personal tax base was comprehensive income, the latter

four reflect the increasing tendency among tax specialists to favour consumption over income as the appropriate personal tax base both for conceptual and practical reasons. A fully comprehensive income tax base involves taxing all current consumption plus net accruals of wealth and is based on the notion that this measures the ability to pay of a taxpayer. Under a consumption tax, only the consumption of the household (or its present value equivalent) would be taxable.

The two tax bases can be shown to differ in their treatment of the returns on asset wealth. The income tax includes all forms of capital income in the base, while the consumption tax does not. This need not imply that the consumption tax is less vertically equitable than the income tax. For both personal tax bases, the rate structure can be chosen independently of the base, so virtually any degree of progressivity can be achieved. On the other hand, the consumption tax has the property that it treats present and future consumption equivalently, while the income tax does not. By taxing future consumption more heavily than present consumption, the income tax could be said to discriminate against savers and therefore be horizontally inequitable. Put somewhat differently, the income tax is said to be a tax on what a taxpayer contributes to the economy (i.e., their income), while a consumption tax taxes what the taxpayer takes out. For these reasons, supporters think of the consumption tax as being the fairer of the two. Of course, nothing is fully unambiguous in the world of taxation. Since neither tax includes the consumption of leisure in the base, it could be argued that the income tax has superior equity properties to the extent that leisure and future consumption are complementary goods. By taxing future consumption more heavily, the income tax would effectively be indirectly taxing leisure in a way that would not be achieved by the consumption tax.

On efficiency grounds, the comparison is likewise ambiguous in principle. If one thinks of the three broad markets in the economy as those for current consumption, future consumption (savings), and leisure (labour), the income tax distorts the taxpayers choice among all three, while the consumption tax distorts only the choice between leisure and consumption, but not between present and future consumption. Thus, the income tax imposes one more distortion on the economy than the consumption tax. However, that does not imply it is less efficient. For a given amount of tax revenue, the income tax imposes a larger tax distortion on the capital market (by taxing savings) but a smaller distortion on the labour market (since the consumption tax needs a higher rate because of its smaller base). Whether or not the consumption tax is more or less efficient than the income tax depends upon whether the additional tax on capital income under the latter is more or less distortionary than the additional tax on labour income under the former. Economic analysis does not give a clearcut answer to this question. However, two consideration should be borne in mind in making the efficiency comparison. One is that there are other taxes that distort labour and capital markets as well as personal taxes. The corporate tax imposes a distortion on capital markets. Its presence would favour the consumption tax on efficiency grounds. At the same time, sales and payroll taxes distort the labour market. A consumption tax would increase the size of the distortion. Second, there are other government policies that might be viewed as working against saving. These include such things as the public debt and public pensions. One may not want the tax system to discourage savings even further.

It is on administrative simplicity grounds that the consumption tax clearly dominates the income tax. Because asset income is excluded from the base, the consumption tax avoids all the difficulties involved in measuring accrued asset income. These include the need to measure accrued capital gains, the need to index capital income for inflation, the need to measure imputed income on housing and other consumer durables as well as on such assets as

cash balances and insurance policies, the need to measure the accrued income of unincorporated business, and the need to measure the rate of return on investment in human capital. Many of these are impossible to measure in practice.

The consumption tax base has its own administrative difficulties, but none are as insuperable as those involved in measuring accrued asset income. Since consumption cannot be measured directly, it is best measured indirectly by measuring income net of saving. What makes this simpler than accounting under the income tax is that all income, capital income included, can be measured on a cash flow rather than an accrual basis, and no indexation is required. Since cash flows are readily measurable, this makes the consumption tax much easier to implement. Of course, because net saving has to be deducted from income, this adds a degree of complexity that does not exist in the income tax. Track must be kept of asset holdings accumulated through tax-deductible savings by all taxpayers since the drawing down of these assets is taxable. This should not be an insuperable task since it is equivalent to what is currently done under the system of RRSPs and RPPs in Canada.

Not all assets can be accounted for in this way in the tax system, however, since some yield returns in a form other than cash. The above treatment requires that all savings in an asset be tax deductible, but all dissavings including those from income earned be brought into the tax base on a cash flow basis. For those assets, such as housing, for which the return is in an imputed form, such accounting is not feasible. Fortunately, there is a method of accounting which is equivalent in present value terms and which is easy to implement. It involves neither deducting the saving when it is done, nor taxing the dissaving from principle and income. In other words, the acquisition of such assets has no tax consequences whatsoever and income generated on them is not taxable. This method of handling assets is

referred to as the "tax prepaid method". The former method may be called the "registered method", because of its similarity to the treatment of registered savings in the current system.

In principle, any asset could be treated on either the tax prepaid or the registered method since they are equivalent in present value terms. In practice, taxpayers could be given the choice, except in the case of certain assets. Those assets whose return takes an imputed form must be treated as tax prepaid. Owner occupied housing is a prime example of this sort of asset. Others, such as human capital investment or asset acumulation in unincorporated business income, must be treated on a registered basis. The tax prepaid method requires that capital income be excluded from the tax base, and that is difficult to do in the case in which capital income, though it takes the form of cash payments, is difficult to measure separately from, say, taxable labour income. Other than these assets, the taxpayer might generally be allowed to choose which to account for on a registered basis, and which to accumulate tax prepaid. The consumer will presumably do so with the objectives of smoothing out tax liabilities as well as reducing the costs of accounting for assets which are likely to turn over fairly quickly (such as bank accounts).

One of the interesting things to recognize about the existing personal tax system is that although it is called an income tax it is in many ways closer to a consumption tax. A substantial proportion of assets are currently treated on a consumption tax basis, either as tax prepaid or as registered assets. Savings for retirement through registered plans are treated on a consumption tax basis. Human capital investment is largely treated on a resistered basis, at least implicitly. Assets whose return take the imputed form are treated on a tax prepaid basis. This includes housing as well as all other consumer durables and cash balances. As well, there are some assets which are taxed on a preferential rate, such as those yielding

capital gains. Until the current income tax reform, the $1000 capital income deduction meant that some ordinary assets were also treated as tax prepaid.

iii. Corporate income tax

As with the personal tax, the main issue concerning the corporate tax is the choice of a base. In the case of the corporate tax, this depends upon the role that the tax is intended to perform. There are two major such roles. The first may be termed the withholding role. According to it, the corporate tax acts as a pure withholding device against corporate source income which would otherwise escape full taxation at the personal level. The second is the rent collecting role under which the corporate tax acts as a means of taxing economic rents in the economy. Depending on which of these two roles one has in mind, the optimal design of the tax will differ.

Consider first the withholding role of the tax, the one which the Carter Report stressed. Withholding is required for two reasons. The first is to prevent domestic shareholders from postponing personal tax liabilities by retaining earnings within the corporation instead of paying out dividends. This rationale presumes that personal taxation is based on income rather than consumption. The other reason for withholding is to tax at source income accruing to foreign shareholders which would otherwise escape domestic personal taxation altogether. There is a large literature on the design of the tax for these purposes. It is generally agreed that the appropriate base is the equity income as it accrues in the corporation.

A proper measure of equity income is difficult to come by. It involves measuring accrued revenues and subtracting from it accrued current costs and accrued capital costs other

than the cost of equity finance, including true economic depreciation at replacement cost, the replacement cost of using inventory, real interest, the replacement cost of depletable assets used, and the capitalized cost of advertising, research and development, and the like.

Many of these items are very difficult to measure and can, at best, only be approximated. At the same time, it is possible to identify several ways in which the existing tax system deviates from true equity income. The current corporate tax reform is intended to correct for some of them and thereby to reduce the extent to which some industries or activities are favoured relative to others. Most of the difficulties involve accounting for capital costs. Depreciation rates often deviate from one's best guess about true depreciation rates. Capital write-offs of all sorts are not indexed. Many items of a capital nature are written off as if they were current expenditures. And, loss offsetting provisions are far from complete. The consequence is that effective corporate tax rates vary considerably across industries, across different capital goods and across sizes of firms.

The second reason for a separate tax on corporations is to tax pure rents. Pure rents accrue to the extent that firms earns revenues in excess of the full economic costs of producing them, including a normal return on capital. Taxes on pure rents are believed by economists to be relatively easy to implement. A tax base consisting of the cash flows of the firm or its present value equivalent will suffice, assuming that positive and negative cash flows are treated symmetrically. The use of a corporate tax as a general tax on rents is probably not practical from a policy point of view since rents are likely to be heavily concentrated in a few sectors (such as resources). However, industry-specific taxes, such as provincial taxes on resources, could readily be designed to be the equivalent to taxes on rents. The advantages to doing so would be substantial since, by their very nature, taxes on rents are non-distortionary taxes.

iv. Sales taxes

Sales taxes can take a wide variety of forms. Our discussion will be restricted to those of relevance for the tax reform in Canada. Only general sales taxes will be considered. Specific (excise) taxes are also widely used by governments on commodities such as tobacco, alcohol and oil products. They are often levied for reasons other than pure revenue raising, for example, as user charges for the use of roads or to charge for externalities. The current sales tax reform does not contemplate changing them and they are relatively inconsequential for the issue of taxing housing so we will not discuss them further.

The various issues surrounding the choice of the sales tax structure will be discussed here. There is, however, one overriding feature of sales taxation that bears stressing and that is its relation to personal taxes. A fully general sales tax which includes in its base all final demands in the economy has the same base as a personal income tax, while that which excludes only investment goods has the same base as a personal consumption tax. The only difference is that while one is levied on transactions, the other is levied on persons. If tax rates were a constant proportion of the base, the taxes would be virtually identical.

It is natural then to ask why a general sales tax is needed in addition to a personal tax system. Many economists might argue that it is unnecessary. One reason might be that different types of progressivity can be achieved under the two bases. A personal tax obtains progressivity by the use of a graduated rate structure combined with a system of exemptions or credits which take personal circumstances into account. A sales tax obtains progressivity by using a rate structure which is differentiated by commodity. Thus, those goods which are relatively more important to low income persons might have a lower sales tax rate. The

progressivity obtained in this way cannot be replicated by a personal tax. This feature of the sales tax is lost if the progressivity is obtained by a system of tax credits administered through the income tax. In this case, the incidence pattern of the sales tax can be replicated by the personal income tax.

It is unlikely that this is the sole, or even the main, policy reason for having a separate sales tax. Even with very similar bases, a government may prefer to spread its tax collections between personal and sales taxes. Doing so keeps the average tax rates for each lower and may therefore encounter less taxpayer resistance. More importantly, spreading the tax across two taxes bases may reduce the possibility of evasion. The incentive to evade a tax is lower the lower is the rate. As well, some taxpayers may find it easier to evade one type of tax rather than the other. Including both taxes in the net ensures that at least some taxes will be paid by such taxpayers.

The question of the appropriate mix of the tax system between personal and sales taxes is more a policy question than an economic one. Many of the advantages of a sales tax are more perceived than real. An example is the argument that a sales tax assists the economy in international markets (see the discussion below). However, it could be argued that, whatever the mix chosen by policymakers, the bases should be consistent with one another. This will reduce economic effects resulting from changes in the mix. The issue of consistency of the bases will be important in considering the treatment of housing under a general sales tax.

We turn now to a brief consideration of the main issues in designing a general sales tax.

a. Single vs. Multi-stage Tax

The tax can be levied on the full value of sales at a single stage, or, equivalently, it can be levied on the value added on all stages of production up to and including the stage used in the single stage variant. The single stage tax has the advantage that fewer taxpayers are brought into the tax collection process so compliance costs are expected to be lower. As well, it is relatively easy to exempt particular transactions from the tax and to impose differential rates. However, it suffers the major disadvantage that it is difficult to ensure that business inputs are excluded from the tax. For example, if the base chosen is the retail level, only final sales at that level should be taxed. However, some goods sold at the retail level can be used both as final consumer goods and as business inputs (e.g., automobiles). The inability to exclude business inputs causes a cascading of taxes which distorts production decisions in the economy. Department of Finance estimates, some of which are reported in the White Paper, indicate that this is a significant problem under the current manufacturing sales tax.

The multi-stage option can take different forms. The two main variants are the subtraction method tax and the credit method (sometimes also referred to as the invoice method). A third possible method, called the addition method, might also be used but is unlikely to be recommended in practice. It involves simply adding up the various sources of taxable value-added directly at the firm level. According to the subtraction method, each taxpaying firm calculates its own tax base as the difference between its total revenue from sales and its purchase of all non-labour inputs. It then pays a tax on this base. This was the method that would have been employed in the so-called Business Transfer Tax advocated in an earlier Department of Finance discussion paper. The credit method is that used in the value added taxes (VATs) of European countries and elsewhere. Under it, taxpaying businesses

include in their tax liabilities the appropriate tax rate applied to their total revenues but are allowed a credit against tax liabilities equal to all taxes that have been paid on inputs into their production processes. These tax credits are recorded on sales invoices obtained on purchases of inputs from the previous stage. Both methods will end up taxing the same base, which will, in turn, be the same as if a single stage tax is used, provided all intended transactions are included in the net.

Both the subtraction and the credit methods of administering multi-stage taxes have the advantage over the single stage method that business inputs are excluded. The subtraction method, which is based on the principle of self-assessment, is also relatively easy to administer provided the base is quite general and the rates are uniform. If exemptions are widely used and if differential rates are employed, the simplicity of the subtraction method is lost because extensive records must be kept of taxes paid on inputs. Under the invoice method, it is relatively easy to allow for exemptions and differential rates. However, the requirement to keep invoices for all transactions within the taxed sector adds to the costs of administering the tax, especially for the private sector. At the same time, it provides a self-policing aspect to the system which improves compliance. In the end, this additional cost of record-keeping must be set against the benefits of self-policing and of ensuring that business inputs are excluded from the base.

b. Retail vs. Wholesale vs. Manufacturing Level

Whether a single- or multi-stage option is used, the choice of the final stage at which the tax is levied must be made. The advantage of choosing a higher level is that the tax is more general. The retail level tax can bring all final transactions into the net. Taxes levied at earlier stages have the administrative advantage of having fewer taxpaying units, but they

have several disadvantages as well. They are less general so end up imposing a higher rate on a smaller number of transactions, thereby introducing distortions among various goods. Taxing at earlier stages also induces administrative difficulties for vertically integrated firms which encompass the stage at which the tax should be levied. Similar problems exist for taxing imported goods, assuming that is desired (see below).

In general, the case for using the retail level seems to be strong. The main problem with it may be political. Since the provinces already occupy the retail level, the federal government may, in the past, have been deterred from using it. As well, taxes levied at the retail stage are more visible to the final purchaser than those levied at earlier stages.

c. Consumption vs. Income Version

A sales tax levied up to the retail stage can be on consumption goods only, or it can include investment goods as well. The latter version distorts both capital and labour markets, while the former distorts only labour markets. Virtually all sales tax systems are levied on a consumption basis, precisely to avoid discriminating against investment and savings. This seems reasonable given that there are many other elements in the public sector which work against savings and capital accumulation (including corporate taxes, public debt and public pensions as already mentioned).

d. Origin vs. Destination Bases

The tax base can vary depending on how it treats exports and imports. An origin-based sales tax applies to exports, but not to imports. All domestic producers pay the tax on all sales whether or not they are exported. No credit need be given on purchased imports.

Such a tax is equivalent to a tax on domestic production. A destination-based sales tax applies on imports as they enter the country. The tax on export goods is rebated. This tax is equivalent to a tax on domestic consumption. From an economic point of view, the two taxes are equivalent if they are levied on a fully general basis. However, policymakers seem to prefer the destination version because of the perception that it is more beneficial to exporters and domestic import-competing industries. If anything, it is slightly more complicated to administer because of the need to deal explicitly with imports and exports. This complication extends to the provincial retail sales taxes which use the destination principle as well.

e. Exemptions and Differential Rates

The government may want different commodities to bear different rates for equity and other reasons. Such goods as food, children's clothing, medical expenses, etc. might be examples of these. They may also want particular sorts of institutions to be tax exempt, such as charitable foundations, educational institutions and government agencies. Under a single stage tax, this is reasonably easy to accomplish provided one wants to exempt the full final sale price. It would not be possible to exempt the value added at only one stage.

With a multi-stage tax, several options are available, though it must be recognized that special treatment of most kinds will involve additional recordkeeping. Transactions may be exempt from the tax. These are referred to as tax-exempt supplies by the White Paper. In this case, the selling firm neither pays a tax on revenues nor receives a credit on taxes levied at previous stages. The effect of this is to eliminate the tax liability on the value added at the exempt stage only. This may be desired if one wants certain types of institutions not to bear a tax on their operations for, say, social reasons, or to keep certain

types of small taxpayers out of the taxed sector to save costs of administration (e.g., small unincorporated businesses). It is administratively relatively difficult to allow exemptions at stages earlier than the final one, or on goods that are eventually exported under the destination method. The reason is that sales from the exempt stage to a subsequent taxable stage will incorporate taxes that have been paid at earlier stages and which ought to be credited to avoid cascading. To do so, tax records from earlier stages must be kept, a complication which is not present under a fully general tax. One of the advantages of exempting certain transactions, which is to keep certain types of taxpayers out of the taxpaying category, is thus partly lost.

Alternatively, some sales may be zero-rated. The White Paper calls this tax-free supply. In this case, not only is the final transaction tax free, but also credits continue to be given on taxes paid at previous stages. If the good is for final sale (or for export under the destination basis), the effect is to exempt its full sales value from tax. On the other hand, if it is used as an input into a further stage of production, it will be fully taxed there under the invoice method, so there will be no net effect on the final selling price. (Under the subtraction method, credit will be given for previous taxes paid when, in fact, none have been.)

Finally, different goods may be subject to different tax rates. In principle, the problems here are identical to those involved with exempting or zero rating. In both cases some record of invoices must be kept.

f. Durable and Used Goods

Special problems arise with the taxation of certain types of items of consumption. One which is particularly important for our purposes is the case of consumer durables. Here the consumer services do not involve market transactions (unless they are rented) but are imputed services. Conceptually, this is identical to the problem already discussed with taxing consumer durables under a personal consumption tax. The solution is similar as well. The only feasible way to treat consumer durables under a sales tax is to tax them on a pre-paid or cash flow basis; that is, to tax them on their full purchase price when acquired, but to exempt the taxation of the services obtained from them at a later date. In present value terms, the purchase price of the durable should be equivalent to the value of future services obtained from them. This requirement to tax durables on a prepaid basis causes two problems. One is that, because the tax is paid up front, it increases the financing required to purchase the durable. Consumers facing liquidity problems may be discouraged from buying them. Also, with the tax paid up front, the rate of tax applicable will be that when the good is purchased. If the tax rate should change, it will be dificult to apply the changed sales tax rate to the remaining services on the durables.

Related to the durability problem is the fact that used goods markets exist for many consumer durables, including housing. In principle, one could bring used goods sales into the tax net in a multi-stage tax system, though it would be difficult to do in a single-stage system without cascading. Bringing in used goods into the tax system would partly correct for the problem of changing rates as mentioned above. It would also bring into the tax base any capital gains on the asset due to changes in the relative value of services. At the same time, it might add considerably to the administrative costs of the system. As discussed later, it is likely to require bringing many more taxpayers into the sales tax net. Also, it requires

some additional bookkeeping to keep track of taxes that had previously been paid on used goods.

f. Federal-Provincial Problems

Special problems exist in the Canadian context because of the fact that all provinces but Alberta have their own single-stage retail tax systems, each of which has a different base and rate structure. As the federal government has recognized, it can either impose their own sales tax on top of those of the provinces, in which case it can be basically of any design the government chooses, or it can coordinate its sales tax system with those of the provinces. The latter option would be the preferred one from a tax harmonization point of view. However, it would involve initial agreement on a common base, as well as agreement on future base changes. It should also allow for a mechanism for determining the division of tax room between the two levels of government and for independent rate level choice by the provinces. Differences in rate structure could also, in principle, be allowed, but they would add considerably to the costs of administering the system. A common federal-provincial sales tax regime with different rates by province would require invoicing for administrative purposes.

We now turn to application of these principles to the tax treatment of housing in the tax system.

II. Conceptual Issues in the Tax Treatment of Housing

Housing raises special issues in the design of a tax system both because its importance as a component of household budgets, and because of the special features of housing as a commodity. Housing is a consumer good of considerable durability which requires a large initial outlay and yields services over a long period of time with relatively little depreciation. This durability makes it suitable not only as a source of consumer services but also as an asset in which to hold household savings. Indeed, for a substantial proportion of households, housing is the major asset held, and is a main form of wealth bequeathed to heirs. Its durability also implies that its existing stock relative to the flow of new housing is also large, and this gives rise to a substantial market in used housing which has important implications for tax design. However, it is an asset unlike most other assets in that its return comes mainly in an imputed form (i.e., as consumer services), at least if it is owner occupied rather than rented. (Not all of the return on owner-occupied housing is imputed; some takes the form of accrued capital gains.) Furthermore, its ownership pattern can take various forms. It may be wholly owned by the consumer. It may be partly owned and partly financed by a mortgage. Or, it may be rented from another owner. Finally, because of its durability, a large proportion of the sales of houses involves used houses, and this gives rise to special and important tax problems.

Ideally, the tax system should not distort the decision as to whether to own a house outright or partly, or whether to rent. This is the so-called tenure decision. It would also be desirable to treat the consumption services of the house on a par with other consumer services. Finally, it would be desirable to treat its investment value comparably with other assets. Unfortunately, given the existing tax system, it is not possible to accomplish all these

things at the same time. We proceed by considering issues in the treatment of housing under each of the major taxes.

i. Housing and the Personal Tax System

The appropriate treatment of housing in the personal tax system depends upon the base being used. It is instructive to consider the proper tax treatment of housing under both a personal consumption tax and an ideal comprehensive income tax. Doing so will make it clear that the existing system is currently much more in line with consumption tax treatment than with income tax treatment. In addition, the principles involved in taxing housing under a personal consumption tax are directly applicable to taxing housing under a general sales tax.

If a comprehensive income base is being used, the full imputed income of holding housing as an asset should be included. In principle, this should include the imputed rent on the equity ownership of the house net of any depreciation but inclusive of accrued (real) capital gains. Mortgage interest indexed for inflation should be deducted. For owner occupied housing, this net imputed rent is obviously difficult to calculate since the rent is not actually reflected in a market price. Even if the house is rented by the owner, it is not a straightforward matter to calculate the depreciation deduction to arrive at net rent.

Not surprisingly, few income tax systems actually treat housing in the ideal way. Imputed income is often not included in the tax base, the exception being most continental Western European countries. In Canada, for example, imputed rent on owner occupied housing is not included in the tax base, but mortgage interest, maintenance costs and property taxes are not deductible. The income from rental housing is, however, fully taxed as business income.

The effect of this is to provide a tax incentive to own a house for one's own consumption rather than holding wealth in the form of another asset. Rental housing is treated on a par with other assets, at least as far as general tax rules are concerned. In fact, preferential depreciation rates on other assets (e.g., machinery and equipment) may work against rental housing. On the other hand, the preferential tax treatment of capital gains presumably works in favour of home ownership. Overall, it is not clear whether the personal tax system favours rental housing over other assets. What is clear is that it favours owner-occupied housing over other assets including rental housing.

Some countries, for example, the U.S., treat owner-occupied housing even more favourably than rental housing by affording a deduction for mortgage interest. This is clearly inappropriate. It amounts to giving an interest deduction on an asset whose return is not taxed in the first place, except to the extent that capital gains on such housing are taxed.

Under a personal tax based on consumption, the tax treatment of housing would be much different from that under an ideal income tax. In principle, a consumption tax base should include the current consumption services of the house (or any other durable), but not the initial purchase price or any maintenance or improvement expenditures. This, of course, would be exceedingly difficult to administer. However, an alternative is available which is equivalent in present value terms. That is to include in the tax base all expenditure outlays on the house, including the purchase price plus all subsequent improvements and maintenance. The value of these expenditures equals the expected present value of all future consumer services in a well-functioning market economy. Including all housing expenditures in a consumption tax base as they occur is straightforward since it is equivalent to treating housing on a tax-prepaid basis. That is, no deduction is allowed for housing expenditures, but

no attempt is made to include any imputed returns. Also, no mortgage interest deduction is allowed. This is basically the way in which owner-occupied housing is currently treated under the existing so-called personal income tax.

Rental housing owned by unincorporated households could be treated in a similar way in principle. However, for administrative reasons, it is preferable to treat unincorporated businesses, including the provision of rental housing by individual property owners, as a registered asset under a consumption tax system. This is because of the practical difficulties of distinguishing the capital income from owning assets, which should be tax exempt under the tax prepaid method, from the labour income of the owner, which should be taxable. Treating housing as a registered asset involves including in the tax base cash flows resulting from transactions in housing assets plus income and current expenses from renting the house. Thus, the purchase price and all maintenance and improvement expenditures would be expensed immediately, while all inflows from rents and house sales would be taxable. The household doing the renting would not be allowed any deduction for the rental payments. This treatment is equivalent to taxing the consumption services of the house. It differs from the treatment of rental housing under the existing income tax which effectively taxes both the current consumption services of rental housing plus the capital income it yields to the owner since owners cannot deduct the cost of equity financing. Therein lies the distorting effect of the tax system on tenure choice. The tax treatment of housing owned by corporations leads to special problems which are treated under the corporate tax below.

While this prescription for the tax treatment of housing under a personal consumption tax is conceptually straightforward, there are some potential problems that might arise in some circumstances. Under the tax prepaid method used for owner-occupied housing, the full tax on the consumption of housing services is effectively paid up front. In itself, this skews

the time profile of household tax liabilities and could tighten the liquidity constraint which households might face in capital markets. In a fully fledged personal consumption tax, the household could effectively correct this by arranging the mix of registered and tax prepaid assets so as to induce any desired time pattern of tax liabilities over the life cycle.

Another problem with the tax prepaid method is that because the tax is levied up front, it is based on the expected value of future consumption benefits (perhaps adjusted for some element of risk). Unexpected future changes which change the value of consumer benefits effectively go untaxed. It is not obvious that anything can be done about this, given that consumer services from housing are difficult to measure in the first place. A related problem is that tax rates change over time. The tax implicitly levied at the time a house is acquired may differ from that applicable when the services are actually consumed. Again, it is not clear that this problem can be avoided. Given the relatively long life of housing, both of these problems are likely to arise.

Finally, it should be noted that the fact that housing is often used as a bequest poses no particular problems. If bequests per se are not taxed but consumption is, housing can pass from one generation to another with no tax consequences since the consumption tax has been already prepaid. If a bequest tax is introduced, housing would be treated under it as any other asset passed on to one's heirs.

It might seem strange to spend so much time discussing the tax treatment of housing under a personal consumption tax, when such a tax is not actually used. There are several reasons for this. One is that the existing system is in some ways closer to a consumption tax than to a comprehensive income tax. In particular, housing in its owner-occupied form is treated on a consumption tax basis under the personal income tax. Second, reform of the

personal tax in the direction of a consumption tax is still very much an option on the tax reform agenda. It has been recommended by many influential policy documents, and is being advocated by the economic advisors of the two major presidential candidates in the U.S. Third, the sales tax reform is concerned with taxing consumption on a broad base, and the principles applying to personal consumption taxes are equally applicable to taxing housing under a general sales tax. Finally, the evaluation of housing relative to other investment assets requires a clear understanding the its existing tax treatment and the available options.

ii. Housing in the Corporate Tax System

The corporate tax affects housing both directly insofar as rental housing is owned by corporations and indirectly through its affect on the supply of housing (land development, construction and real estate industries). The tax is, roughly speaking, meant to be a tax on the equity income of the corporations and is intended to fulfil a withholding purpose, as discussed earlier. As such, it it imposes a distortion on investment financed by equity funds. In an ideal world, the tax would be a pure withholding device and these distortions would be undone by a system of crediting (integration) for taxes eventually paid at a later stage. There are a number of reasons why the existing system of integration, consisting of the dividend tax credit, does not undo the corporate tax distortions. For one, the dividend tax credit rate does not match the various average corporate tax rates that the crediting is meant to apply to. Because of differential corporate tax rates, various corporate tax incentives and the absence of full loss offsetting, some shareholders are undercompensated and others are overcompensated by the dividend tax credit. More fundamentally, however, it has been shown that in a country with an open capital market, such as Canada, the dividend tax credit, even with perfectly differentiated rates, is not an effective device for undoing the effects of the corporate tax. The reason is that if the interest rate is internationally determined and fixed

as far as the domestic economy is concerned, the savings side of the market is effectively separated from the investment side. Tax measures operating on the firm affect the investment side while those operating on the household affect the savings side. The dividend tax credit therefore does not undo the distorting effect of the corporate tax on investment; it merely subsidizes savings.

The distorting effect of the corporate tax varies across industries and activities because of the imperfect way in which the equity income base is measured, particularly because of the anomalies in accounting for capital costs. Attempts have been made to capture some of the distorting effect of corporate taxes across industries by use of the concept of a marginal effective tax rate, which is basically a measure of the amount of tax collected on an investment which is just marginally profitable. Interindustry marginal effective corporate tax distortions have been reported in a variety of places. The White Paper itself reports that the effective corporate tax rate on new investments in the construction industry is 36.7% and in the retail trade industries is 37.1% compared with an economy-wide average of 24.6%. Similar qualitative results have been obtained elsewhere. (See, for example, Boadway, Bruce and Mintz [1987], and Daly and Jung [1987]).

In summary, the corporate tax inevitably imposes a tax on corporate investment financed by equity funds. The tax may or may not vary by industry. What evidence exists suggests that the industries involved in producing housing, whether for rent or owner occupancy, may bear a higher tax than other industries such as manufacturing and primary industries. At the same time, it is clear that housing produced in the corporate sector faces a tax disadvantage relative to housing produced by unincorporated firms.

iii. Housing in a General Sales Tax

The consistent tax treatment of housing in a general sales tax follows principles similar to those discussed under the personal consumption tax. For owner-occupied housing, the equivalent of taxing consumer services can be achieved by taxing the purchase price of the house as well as any expenditures by the owner on maintenance or improvements. This can readily be accomplished by a retail stage tax of either the single- or multi-stage variety.

Rental housing is also straightforward. Fully consistent treatment would treat rental housing the same as owner occupied housing; that is, on a tax prepaid basis. It would be fully taxable on the acquisition by the landlord of the housing itself. In a single-stage option, that would be the end of the matter. If a multi-stage option is used, the final house seller would be taxed on the sale of the house, but would be credited for taxes already paid on taxed inputs used in producing the house. Such a system will ensure that choice of tenure will be unaffected by the tax system. That is, the same tax liabilities will accrue whether the house is owned or rented. Value added provided at the rental stage will exempt from tax in the case of rentals. But, value added which is self-supplied by owner occupiers will also be exempt.

While the principles of taxing housing services (and other consumer durables) consistently with other consumer goods are relatively straightforward, there are a number of special problems that arise in practice. These will be dealt with in some detail below; here they will simply be introduced. A major issue arises during the transition to a new sales tax and that concerns how to treat the existing housing stock. This involves both matters of principle and of practicality. The question of principle is whether the future consumer services of existing housing ought to be included in the tax given that their value already

capitalizes previously-existing taxes that were expected to exist when the house was purchased. If the answer to that question is no, then old houses would be excluded from the tax; only new houses would be taxed. Improvements to old houses should presumably be taxed, although it could be argued that maintenance should be excluded. In practice, this distinction might be difficult to administer.

On the other hand, if it is desired to tax all future housing services from whatever source, old housing must be brought into the net. The means of doing this are discussed later. The fully consistent way would involve a once and for all tax on the stock value of houses existing at the time of the transition. Alternatively, old houses could be taxed on their first sale. This would be less general than the first method since houses which are never sold would escape the tax, while those which are sold after a time lag, but in a depreciated state, would be preferentially treated. In all cases, the whole or partial taxation of old housing involves some administrative costs. At the same time, relatively large tax revenues are involved.

Another potential problem with taxing owner-occupied housing on a tax prepaid basis is the possible liquidity problems that it may induce for purchasers. To repeat, since the tax is paid up front, it adds an element of financing requirement in the purchase of the house which would otherwise not exist. Whether or not there are ways of alleviating this, say, by postponing tax liabilities will be considered later.

Yet another problem concerns the sale of used houses which re-enter the taxed sector (e.g., through a real estate firm). If used houses are exempt from the tax, the value added in the used housing market will be excluded from the tax base. On the other hand, including that value added in the tax net gives rise to administrative problems. For example, some

record must be kept of the taxes, if any, that had been previously paid on the house. If the last transaction was a long time before, proper accounting will be difficult. These and other administrative problems will be considered in more detail in later sections.

One final issue concerns the treatment of land relative to structures. As discussed in the following Section, some European countries distinguish between the two, attempting to include only that component of new housing in the tax base which represents the value of structures. The argument is psesumably based on some legalistic notion of what constitutes the "value added" in a house. Since the land is in a sense already given, value is added only to the extent that structures are added to the land. Thus, these tax systems try to reduce the value of a new house sale by some estimate of the value of the land in the selling price of the house. From a purely economic point of view, this disaggregation is unwarranted. A multi-stage sales tax is intended ultimately to tax the final value of consumption services in the economy. The selling price of the house, including the full value of land and structures, should represent the present value of the flow of future consumption services from the house. This is precisely what one would want to include in the tax base under a general sales tax, assuming that housing is to be treated on a tax prepaid basis. Naturally, to be fully general, the tax should include the full value of both new and existing housing. To the extent that it does not, land which is already a component of the existing housing stock would go untaxed. On the other hand, any land which is currently undeveloped, but which eventually becomes developed will enter the tax base if the full value of new housing is taxed. This would be fully appropriate.

III. The Taxation of Residential Housing in OECD Countries.

As described in Section II, housing is taxed under the various components of the tax mix in a country. In order to acquire a complete picture of the taxation of housing in different countries for the purpose of comparison, it is necessary to consider all of these components. In this section we compare the various taxes imposed on housing in the major OECD countries. The taxes considered include sales taxes on new and existing housing; real estate transfer taxes, stamp duties, and registration fees/taxes on new and existing housing; net wealth, property and cadastral taxes; and personal income taxes. Under income taxes we look at the taxation of market and imputed rents, deductions and credits for owner-occupied housing (OOH), and capital gains taxes on OOH. Information on the corporate tax system as it applies to residential housing and construction is not readily available for OECD countries as a whole so it is excluded for this cross country comparison. Information about the impact on housing of the corporate tax in Canada is found in Fallis and Smith [1988] and in Section II.

The tax treatment of housing varies widely across the countries we consider. Several generalizations can be made, however. First, countries which subject construction (new housing) to a VAT sales tax generally exempt rentals and sales of existing housing. Second, such countries usually apply substantial real estate transfer taxes to sales of existing housing. These transfer taxes generally are not applied to housing subject to the VAT. Third, many countries that subject new housing to the VAT do so at a preferential rate or exempt land and subject it to a lower transfer tax. Fourth, nearly all countries offer some sort of tax breaks on residential property in comparison to commercial property or in comparison to a "neutral" tax treatment. Fifth, many countries have other tax provisions which yield benefits specifically to OOH. Sixth, countries divide about equally into those that tax imputed rents

from OOH and those that exempt them. Countries which tax imputed rents usually allow deductions for mortgage interest and maintenance costs, in some cases limited to the value of imputed rents. Of countries which exempt imputed rents on OOH, a significant number allow for mortgage interest or other expenses associated with OOH even though the return to OOH itself is not taxed. Seventh, most countries exempt capital gains on OOH although some of these levy personal wealth taxes.

We now consider the taxation of housing in OECD countries in greater detail. An Appendix tabulating the major features of the taxation of residential housing for each country is found at the end of the section.

i. Sales Taxes on New Housing.

Construction of residential housing is included in the VAT base for most countries levying this tax, although preferential treatment is not unusual. The U.K. zero-rates residential construction which means that the VAT is removed from the value of a new house. Finland exempts housing construction from its turnover tax. Reduced VAT rates apply generally in Belgium, Ireland and Sweden where, in the the latter, the full VAT rate applies to only 60 per cent of the value of the construction. The land component of the value of a new residence is exempt from the VAT in Belgium, Denmark, Germany, Ireland and Spain while in France it is subject to a reduced rate. In Denmark, Germany and Ireland the attached land is subject to a real estate transfer tax but at a much lower rate. Much reduced VAT rates apply to "non-luxury" housing in Italy and Portugal and the sale, but not construction, of low-cost housing provided by social housing associations is exempt from the VAT in France.

We do not know how difficult it is to administer these special provisions. In general, a special rate under an invoice type VAT does not pose inordinate difficulties. The U.K. has encountered a lot of difficulty with its zero-rate treatment but this is because it fully taxes repair and maintenance expenditures but not improvements. (Recently, because of the difficulties, it has brought improvements into the VAT base.) Also, the U.K. zero-rate treatment for commercial and industrial buildings recently has been found to violate the European Economic Community's Sixth Directive concerning tax harmonization (the Economist, [1988]). The special treatment of the land component poses problems where the land and building are sold together by the builder. Taxing the land component preferentially would invite the builder to overstate the land value for tax purposes. Reduced VAT rates for low-cost housing would cause "unbundling" of the housing package. Partially finished housing would be sold to get that component under the ceiling for the reduced rate with the completion, at the full rate, carried out after the sale.

ii Sales and Transfer Taxes on Existing Housing.

Rentals and sales of existing housing are exempt from the VAT in nearly all of the countries levying a VAT but the sale of existing housing is subject to real estate transfer taxes in most of these countries. There are no input tax credits available when a sale is exempt so any taxes applied upstream are included in the price charged and only the services of the landlord go untaxed. The services of the property itself are taxed on a prepaid basis if the existing house was constructed when the VAT was in force. In France, Germany and Luxembourg, landlords can opt to include rentals in the tax base. In Belgium, "immovable leasing" is subject to the VAT, and in Ireland and the Netherlands leasing may be subject to the VAT depending on the length of the lease. The taxation of leasing is presumably to control self-supply whereby a builder constructs a residence and leases it rather than sells it.

In Ireland and Italy a reduced VAT is imposed on existing houses sold by taxable persons but the reduced rate is only available on "non-luxury" dwellings in Italy. In Turkey the sale of existing housing is subject to VAT if the sale is part of the seller's "usual activity". A turnover tax on movable goods applies to the sale of prefabricated houses in Finland (recall construction is exempt) and the full VAT is imposed on 60% of the value of prefabricated houses in Sweden. In Spain, a reduced 6% VAT applies to houses sold after "major renovation" but this is in lieu of a 6% real estate transfer tax and the full VAT applies on houses transferred by financial lease corporations. The latter again appears to be a self-supply control.

Although the sale of existing housing is exempt from the VAT in most countries, it is usually subject to real estate transfer taxes or a stamp duty on the attached documents. In some cases these transfer taxes are applied at substantial rates. For example, in Belgium a registration duty of 12.5% applies on the sale of all land and buildings (compared to a reduced VAT of 6% on construction). In most cases the transfer taxes do not apply if the property transferred has been recently subject to the VAT. Thus the transfer taxes are, to some degree, in lieu of the VAT. In Austria, Ireland, Portugal and the U.K. the transfer taxes apply only to property over a certain value. In Italy, the transfer taxes are nominal (50,000 Lire) if the property was recently subject to the VAT. Also, a much lower rate is applied to "non-luxury" dwellings. Transfer taxes apply to the sale of new housing in Finland, Germany, Italy, Luxembourg, Spain, Sweden, and the Zurich Canton. Stamp taxes are also applied to mortgages in Finland and Sweden.

While the real estate transfer taxes can be construed as a means of taxing the services of existing housing on a prepaid basis, it should be stressed that these levies are turnover

taxes and are subject to cascading. There are no provisions for crediting real estate transfer taxes that were paid on prior transactions except in Luxembourg which allows partial refund of real estate transfer taxes to the current vendor if the property has been held for less than four years. The cumulative effect of such turnover taxes provides a great incentive to lock-in ownership reducing the liquidity of the housing market and poses a major barrier to geographic mobility.

iii. Net Wealth, Property and Cadastral Taxes.

The value of existing residential property is taxed under property and net wealth taxes. Austria, Denmark, Finland, Germany, Luxembourg, the Netherlands, Norway, Spain, Sweden, and Switzerland all impose taxes on net wealth. These taxes are progressive because of a graduated rate structure, exemptions for each family member, or both. The value of residential property less outstanding mortgages and debt is included in the base of this tax. In the Netherlands, only 80% of the net value of OOH is included in the wealth tax base. Norway also includes only part of the value of OOH in its net wealth tax. In Austria, Germany, Luxembourg and Spain, the personal exemptions are so great that only luxury housing would be taxed.

Most countries except Belgium, Finland, Italy, and Portugal have local or national property taxes. Belgium taxes cadastral income but this tax is creditable against personal income taxes. Portugal levies a "complementary" tax on the imputed income of homes exceeding 1 million escudos owned by high income families. Ireland exempts real estate with market value under 68,728 IR pounds (1986, indexed) from residential property tax. The U.K. proposes to replace local "council rates" with a "poll tax".

Property tax rates vary widely within and across countries. Also, the value of the property for tax purposes is determined in different ways so a cross country comparison is extremely difficult. Also, in many cases the property tax finances local services so it is partly a user or benefits tax. France, Germany, Spain, and Luxembourg impose property tax burdens which match or exceed those imposed in Canada. As mentioned, the net value of real estate property is included in the wealth tax of many countries.

Several countries give p artial property tax "holidays" on newly constructed housing. In France, a two year exemption from local property taxes is granted for newly completed houses. Local property taxes are reduced by 50% for 3 years following construction in Japan and taxable property value is reduced by 25% for 5 years in Turkey.

iv. Income taxes.

Income from residential housing is taxed preferentially in comparison to pure income tax neutrality, and perhaps most commercial capital[1], in most countries. The main tax preferences involve the taxation of rental income, the exclusion of imputed rents, deductions and credits for OOH expenses, and the taxation of capital gains on OOH.

Income to landlords from rentals is taxable in all countries. Reduced tax rates on real estate income is applied for approved housing associations or corporations in Belgium and France. Accelerated depreciation on residential housing is allowed in France, Germany and the Netherlands. (Canada has phased out similar accelerated depreciation provisions for

[1]To establish that residential housing is taxed preferentially to commercial capital it would be necessary to examine all of the tax preferences available to commercial capital as well as residential capital. This is beyond the scope of this study.

multiple-unit residential buildings (MURBs)). Spain allows a 17% investment tax credit against rental income.

Imputed rent on OOH is exempt from tax in Austria, Canada, France, Germany, Ireland, Japan, Turkey, the U.K. and the U.S.A. Finland taxes imputed rents in excess of 300,000 Fmks. In countries which levy tax on imputed rents, mortgage interest and other expenses (maintenance or depreciation) are deductible. Spain allows a 15% investment tax credit. In some cases, deductions are limited to the value of the imputed rents themselves (that is, negative imputed rents are not possible). Belgium limits mortgage interest deductions to imputed rents on existing housing but allows mortgage interest deductions in excess for VAT paid houses in the first twelve years. Standard deductions are allowed in Denmark and Sweden.

Several countries which do not tax the imputed rent on OOH nevertheless allow certain deductions and credits for the cost of the OOH. Since the return to OOH is not taxed, these measures constitute a straight subsidy to OOH. For all intents and purposes, an unlimited mortgage interest deduction is allowed in the U.S. Limited mortgage interest deductions or credits are allowed in France, Ireland, Japan, and the U.K. Depreciation is deductible in Germany (including half of land value) and maintenance expenses in France (specified) and Turkey. Property tax is deductible/creditable in Denmark, Netherlands and Spain, which tax imputed rents on OOH, and in the U.S. and Japan which don't. Property tax credits are available to low income households in some Canadian provinces. Since property taxes can be conceived as payments for municipal services, deductions or credits are viewed as concessionary whether or not imputed rents are taxed. In New Zealand, in contrast, property taxes, known as local body charges, are subject to the GST as a consumption expenditure.

Capital gains on OOH are exempt or preferentially taxed in most countries. A taxpayer's principal residence is exempt in Austria, Belgium, Canada, Germany, Finland, France, Ireland, Italy, Luxembourg, Norway, Portugal, Turkey, and the U.K. subject to occupancy requirements that vary across countries. In Switzerland, capital gains tax rates decline with the length of time the residence is held. Exemptions, special rates and adjustments apply in Denmark. An exemption of 40 million applies in Japan and $125,000 for persons over 55 in the U.S.A. and capital gains on OOH are otherwise taxed only if the proceeds are not reinvested in another principal residence within a specified time period. Taxes do not apply to capital gains that are reinvested in OOH and are less than 15,000 Skr in Sweden and 15 million Pta in Spain.

In some other cases, special provisions apply to capital gains on real estate. Capital gains on property are inflation indexed in France, Norway and Spain and apply only on speculative transactions in unimproved land in Belgium, and on speculative transactions in Italy and Portugal. In other countries, capital gains are taxed a special rates. In the U.K., capital gains are taxed at a flat rate of 30% rather than at schedular rates.

This completes the general discussion of the taxation of housing in different OECD countries. Details in tabular form for each of the main OECD countries follow.

III. Appendix

The following tables were constructed from information collated from several sources. The primary sources were "Taxation of Owner-Occupied Dwelling Houses," European Taxation, Vol. 26, #12, December 1986 and Jean-Francois Talon, "Housing Tax Expenditures in OECD Countries," in Tax Policies and Urban Housing Markets, OECD, 1986.

Country: Austria

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- subject to standard VAT rate of 20% - any property subject to transfer tax is exempt from VAT	- sales and rentals exempt
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	exempt	- immovable property transfer tax of 7 or 8% (over 100,000 AS) except sale by building contractor
Wealth, Property and Cadastral	- net wealth tax of 1% on assessed value in excess specified exemption (150,000 AS per family member) - real estate tax on assessed value at varying rate up to .84% in some municipalities	
Income		
Rentals	- market rentals only	
Deductions and Credits	- no deductions for interest, depreciation or maintenance expenses for OOH	
Capital Gains on OOH	- only if speculative transaction (sold within five years of acquisition)	

Country: Belgium

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- special reduced rate (6% from 17%) on dwellings - applies only to buildings - land is exempt from VAT	- sales exempt - "immovable leasing" subject to VAT
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	exempt	- registration duty of 12.5% on sale of land and buildings - new buildings subject to VAT are not subject to registration duty on first sale
Wealth, Property and Cadastral	- immovable prepayment on cadastral income. This is credited against income tax. - no property tax	
Income		
Rentals	- market plus imputed rentals (cadastral income) - special rates on real estate income for approved associations	
Deductions and Credits	- mortgage interest on all up to cadastral income - mortgage interest for 12 year period on newly constructed VAT paid house up to 2,000,000 Bfrs plus 100,000 Bfrs per child	
Capital Gains on OOH	- only an unimproved property held less than eight years	

Country: Canada

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- reduced rate (from 12% to 8%) Federal S.T. on building materials and prefab buildings - Provincial sales tax on building materials in most provinces	exempt
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	n.a.	- Provincial land transfer taxes (.4 and .8 percent in Ontario)
Wealth, Property and Cadastral	- local property taxes ranging from 1 to 3 per cent of market value	
Income		
Rentals	- market rentals only	
Deductions and Credits	- no deductions for interest, depreciation or maintenance on O.O.H. - some provincial deductions or credits for property tax	
Capital Gains on OOH	- principle residence exempt	

Country: Denmark

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- standard VAT rate of 22% on buildings - land is exempt but subject to stamp duty	exempt
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	exempt	- stamp duty of 1.2% on all transfers of immovable property
Wealth, Property and Cadastral	- 2.2% wealth tax on "taxable value" of property - taxable value deducts mortgage debt (but is included in wealth of mortgagor) - local real estate taxes not exceeding 5% of value on unimproved land values	
Income		
Rentals	- market plus imputed rentals on taxable value	
Deductions and Credits	- standard deduction of 1% of taxable value - mortgage interest is fully deductible	
Capital Gains on OOH	- "adjusted" capital gains on immovable property is subject to 50% special tax if property owned less than 7 years - generous exemptions for family dwellings and apartments	

Country: Finland

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- processed building materials and tools - installation of power lines, machinery and sewers taxable - construction is exempt	- turnover tax on movable goods (includes prefab houses) only
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- sale of new buildings subject to stamp tax	- stamp tax at rate 4-6% of purchase price on transfer of real property - stamp tax also applies on mortgages
Wealth, Property and Cadastral	- progressive national wealth tax on value of residence (reduced by 40% of part not exceeding 125,000 Fmk). Mortgages and loans deducted from value. - no immovable property tax	
<u>Income</u>		
Rentals	- market and imputed rents (3% of taxable value in excess of 300,000 Fmk)	
Deductions and Credits	- mortgage interest in excess of 600 Fmk not exceeding 25,000 Fmk	
Capital Gains on OOH	- exempt on principal residence owned at least one year	

Country: France

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- subject to standard VAT rate of 18.6% - person who purchases land (incl. buildings to be demolished) subject 13% rate (30% reduction) - sale (but not construction) of some low-cost housing exempt. (red. effective VAT from 18.6 to 15.5%) - local building tax of 1%-5%	- sales exempt - option to take taxable status on rentals
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- exempt from transfer tax	- transfer tax on dwellings (combined rate 7.1%)
Wealth, Property and Cadastral	- no wealth tax (abolished 1/1/87) - local cadastral taxes at 7% (2 year exemption for new houses)	
Income		
Rentals	- market rents with 15% flat rate deduction for depreciation - housing investment companies exempt from corporate tax on 95% rental income	
Deductions and Credits	- interest on mortgage and loans up to 15,000 Ffrs plus 2,000 Ffrs per person generates tax credit at 25% - specified maintenance and improvements expenses also creditable	
Capital Gains on OOH	- no tax on principal residence - generous exemptions for secondary residence - capital gains tax on other property adjusted for inflation	

Country: Germany (F.R.)

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- standard 14% VAT only where building separate from land - property subject to immovable property acquisition tax is exempt	- sales exempt - option to take taxable status on rentals
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- immovable property acquisition tax of 2%	- immovable property acquisition tax of 2%
Wealth, Property and Cadastral	- .5% wealth tax on assessed property value less mortgage and loans less 70,000 DM per family member - varying local property taxes of about 300% of the net wealth tax	
Income		
Rentals	- market rents only with accelerated depreciation	
Deductions and Credits	- interest deductions abolished for occupancies after 1/1/87 - 5% depreciation deduction on house plus 1/2 value of land in first 8 years (maximum base of 300,000 DM)	
Capital Gains on OOH	- only if property sold within 2 years of acquisition	

Country: Ireland

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- 10% VAT (reduced from standard rate of 25%) on buildings - undeveloped land is exempt from VAT but subject to 6% stamp duty	- 10% VAT applies on sale of existing housing by taxable person - rentals exempt or taxed depending on length of lease
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- stamp duty up to 6% on acquisition of undeveloped land on which house built	- stamp duty up to 6% on documents transferred on property valued in excess of 50,000 IR Pounds
Wealth, Property and Cadastral	residential property tax of 1.5% on excess of market value over 68,728 IR Pounds (1986, indexed)	
<u>Income</u>		
Rentals	- market rents only	
Deductions and Credits	- limited mortgage interest credits	
Capital Gains on OOH	- principal residence exempt	

Country: Italy

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- 18% standard rate VAT reduced to 2% for "non-luxury" dwellings - applies to property sold by taxable person	- 10% VAT reduced to 2% on non-luxury dwellings - applies to property sold by taxable person - rentals exempt
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- registration tax of 8% (reduced to 2% for some "non-luxury" dwellings) - transfer tax of 1.6% - cadastral tax of .4% - above taxes fixed at 50,000 lire if property subject to VAT	- registration tax of 2% (reduced to 2% for some "non-luxury" dwellings) - transfer tax of 1.6% - cadastral tax of .4% - above taxes fixed at 50,000 lire if property subject to VAT
Wealth, Property and Cadastral	- no wealth or property taxes	
<u>Income</u>		
Rentals	- market and imputed rents on cadastral value - local property income taxes	
Deductions and Credits	- mortgage interest deductible up to 7,000,000 lire - maintenance expenses deductible	
Capital Gains on OOH	- only on "speculative transactions"	

Country: Japan

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	n.a.	n.a.
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	n.a.	- 3% transfer tax on market value of buildings
Wealth, Property and Cadastral	- local property taxes (reduced by 1/2 for 3 years after construction)	
Income		
Rentals	- market rents only are taxed	
Deductions and Credits	- tax-free interest on house purchase savings contracts - property tax deductible - mortgage interest tax credit up to 18% of income tax or 150,000 Yen ceiling	
Capital Gains on OOH	- taxed in excess of 40,000,000 Yen if not used to repurchase residence	

Country: Luxembourg

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- house subject to standard 12% VAT	- sales exempt - option to take taxable status on rentals
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- land and house subject to 5-7.2% real estate transfer tax (partial refunds if resold within 4 years) - registration fees of 1%	- land and house subject to 5-7.2% real estate transfer tax (partial refund if resold within 4 years) - registration fees of 1%
Wealth, Property and Cadastral	- net wealth tax of .5% (less allowance of 100,000 Lfrs per family member) - local real estate taxes of 2.1 to 4.75% of assessed value	
Income		
Rentals	- market and imputed rents (reduced by deductible mortgage interest)	
Deductions and Credits	- mortgage interest against imputed rent - no maintenance deductions	
Capital Gains on OOH	- principal residence exempt	

Country: Netherlands

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- standard rate 20% VAT on buildings and land improved by developer (no transfer tax on building VAT paid)	- sales exempt - rentals exempt or taxed depending on length of lease
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- land for construction subject to 6% real estate transfer tax if purchased by individual	- 6% real estate transfer tax on structures
Wealth, Property and Cadastral	- .8% net wealth tax (on 60% of market value of OOH less mortgage value) - local taxes on owner and user of real estate (rates vary across municipalities)	
<u>Income</u>		
Rentals	- market rents less 15% flat rate depreciation and imputed rents taxed	
Deductions and Credits	- unlimited mortgage interest deduction - major maintenance expenses deductible - no depreciation deductions	
Capital Gains on OOH	- no capital gains tax on OOH	

Country: New Zealand

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- fully taxed at GST of 10%	exempt
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- none	none
Wealth, Property and Cadastral	- land tax of 2% on unapproved land in excess of 175,000 N.Z. dollars (exemption is then abated $ for $) - local body property taxes at varying rates. These charges are subject to the GST.	
<u>Income</u>		
Rentals	- market rentals only. Special provisions have been abolished or phased out.	
Deductions and Credits	- none	
Capital Gains on OOH	- none	

Country: Norway

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- standard 20% VAT on building	exempt
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- 1.75% stamp duty on value of land	- 1.75% of stamp duty on transfers of immovable property
Wealth, Property and Cadastral	- reduced value of OOH property less mortgage debt subject to .2 to 1.3% national wealth tax - flat rate local net wealth tax of 1% - municipal property taxes up to .7%	
Income		
Rentals	- market and imputed rents taxed	
Deductions and Credits	- mortgage interest fully deductible - deductions for damage costs	
Capital Gains on OOH	- principal residence exempt if sold more than 10 years after acquisition - adjusted cost base in other cases (e.g., increased by 7% per year of ownership) in other cases	

Country: Portugal

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- standard 17% VAT and .4% stamp duty on building reduced to .25% if price < 10,000,000 ESC	exempt
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- 10% sisa and .4% stamp duty on unimproved urban land - 8% sisa and .5% stamp tax on rural land (10,000,000 ESC exemption if primary res.)	- 10% (sisa) transfer tax - .5% stamp duty on purchaser (10,000,000 ESC exemption for primary res.)
Wealth, Property and Cadastral	- "complementary" tax levied on imputed income of homes exceeding 1,000,000 ESC of high income families	
Income		
Rentals	- market and imputed rents taxed (latter taxed at 18%) state and local surcharges, 9-12% and 5-10% respectively	
Deductions and Credits	- 30% of imputed rent allowed as maintenance deduction - mortgage interest deductible from complementary tax	
Capital Gains on OOH	- 24% capital gains tax on speculative transactions on unimproved land	

Country: Spain

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- reduced VAT (from 12% standard to 6%) on total consideration paid to builder - 12% VAT on construction work only	- 6% VAT (in lieu of transfer tax) on homes that are sold after major renovation - 12% VAT on homes transferred by financial lease corporation
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- .5% stamp duty on construction costs and land - 6% transfer tax on land	- 6% transfer tax
Wealth, Property and Cadastral	- net wealth tax, .2-2%, on wealth less tax free allowance (10,500,000 Ptas for family of four) - 4% urban property tax on 70% of cadastral value (market price)	
Income		
Rentals	- market and imputed rent (3% of cadastral value) - 17% ITC of purchase price against market rents	
Deductions and Credits	- 15% ITC of purchase price - interest deductible up to 800,000 Ptas	
Capital Gains on OOH	- inflation indexed capital gains taxed - first 15,000,000 Ptas exempt if reinvested in principal res. within 2 years	

Country: Sweden

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- 22.6% VAT exclusive rate on 60% of sales value	- 22.6% VAT on 60% of value on prefab homes sold by taxable persons
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- 1.5% stamp tax - 2.0% stamp tax on mortgage	- 1.5% stamp tax on transfer value - 2.0% stamp tax on mortgages
Wealth, Property and Cadastral	- progressive net wealth tax (value of home less mortgage and debt included) (1.5-3%) - 1.4% immovable property tax	
Income		
Rentals	- market and imputed rents (imputed rents are increasing percentage of property value) - 1.5% of property value deemed income for municipal income tax	
Deductions and Credits	- mortgage interest fully deductible - basic deduction against imputed income	
Capital Gains on OOH	- taxed at ordinary rates. Gains of 15,000 skr or more deferred if reinvested in principal residence	

Country: Switzerland

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- 4.65% federal turnover tax on construction work	none
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- Zurich Canton transfer tax of 2%	- Geneva Canton transfer tax of 3% on building also registration and stamp duties - Zurich Canton transfer tax of 2%
Wealth, Property and Cadastral	- Geneva - progressive net wealth tax from .175% to .45%. Also supplementary net wealth tax up to .135%. Additional net wealth tax of .1% on immovable property. - Zurich - progressive net wealth tax from .05% to .3% - immovable property tax of .05%	
Income		
Rentals	- federal and canton income tax applied to market and imputed rent	
Deductions and Credits	- mortgage interest deductible from federal and Canton income taxes. Maintenance expenses deductible from Federal and Zurich income taxes.	
Capital Gains on OOH	- Geneva - capital gains tax on OOH at rates (32% to 8%) declining with time property held - Zurich - municipal capital gains tax decline from 40% to 10% depending on length of time property held	

Country: Turkey

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- goods and services in construction subject to standard 10% VAT - purchase of house is exempt if house is less than 150 sq. meters	- sale of existing subject to VAT only if sale is part of seller's usual activity
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- exempt from transfer taxes if subject to VAT	- fiscal stamp tax - real estate tax - banking and insurance transactions tax
Wealth, Property and Cadastral	- municipal real estate tax of .4% on market value (25% of value exempt in first 5 years)	
Income		
Rentals	- market rents only taxed	
Deductions and Credits	- maintenance expenses fully deductible	
Capital Gains on OOH	- OOH is exempt if owned more than 1 year	

Country: U.K.

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- zero rated except for services provided by architects, surveyors and consultants	- sales zero rated if sold by taxable person - sales and rentals otherwise exempt
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- 1% stamp duty on purchase of land	- 1% stamp duty on homes sold for more than 30,000 Pounds
Wealth, Property and Cadastral	- local property value taxes at varying rates - "poll tax" reforms pending	
Income		
Rentals	- market rents only taxed	
Deductions and Credits	- interest on mortgage principal up to 30,000 Pounds is deductible	
Capital Gains on OOH	- OOH - principal residence exempt - flat rate of 30% on other	

Country: U.S.A.

Tax	Construction (New Housing)	Rentals and Sales of Existing Buildings
Sales	- state and local retail sales taxes on materials	exempt
Real Estate Transfer, Stamp Duties, Registration Taxes and Fees	- some local real estate transfer taxes	- some local real estate transfer taxes
Wealth, Property and Cadastral	- local property taxes on real estate varying in rates across the country	
Income		
Rentals	- market rents only taxed	
Deductions and Credits	- unlimited interest deductions on two residences - property taxes deductible	
Capital Gains on OOH	- capital gains over adjusted basis (purchase price plus improvements) taxed as ordinary income. No tax if rolled over into new residence in specified period. Sellers over 55 have one-time exclusion up to $125,000.	

IV. The Existing and Proposed Sales Tax Systems in Canada

The present system of general sales taxation at the federal level and its disadvantages are outlined in Chapter 2 of the White Paper. Basically, the federal sales tax (FST) is a single stage tax on all sales at the manufacturing level with a differentiated rate structure and some exemptions. The basic rate is 12% and this applies to all taxable goods except alcohol and tobacco products, which are taxed at 15%, and building materials, which are taxed at 8%. Exemptions include food, clothing and footwear. The FST is levied on a destination basis so that exports are exempt while imports are taxed on their customs value inclusive of duties.

Housing is taxed to the extent that manufacturing inputs are used in the production of houses. These are primarily building materials, which are taxed at the preferential 8% rate. As a proportion of the final sales value of the house, this is presumably not too large. Value added by the construction and real estate industries are not taxed, nor is the value of land. Relative to other consumer purchases, housing appears to be taxed relatively lightly. This is confirmed by the estimates of Kuo, McGirr and Poddar [1988] who estimated effective sales tax rates by commodity using 1980 data and tax rates. Their estimates took into account both the direct effect of sales taxation on commodites consumed as well as the indirect effect of the tax on manufactured goods used as inputs in the production of other goods. They estimated that the effective FST rate on residential construction was 2.11% of retail value in 1980. This compares with a standard statutory rate of 9%, with a 5% rate on building materials. This effective FST rate corresponded with the average effective FST rate over all commodities. However, it does not include the land component of housing, which presumably bears little or no tax. At the same time, owner-occupied housing bore an effective rate of .31% on its use of purchased inputs while real estate faced an effective rate of .55%. They

also noted that of all FST revenues collected, 51% came from expenditures on final consumer goods, 36% came from expenditures by businesses on intermediate inputs, and 13% came from machinery and equipment expenditures. Of the business input proportion, three quarters came from the construction, travel, advertising and office supplies industries.

All provinces except Alberta levy retail sales taxes (PSTs), also on a destination basis (from the point of view of the province). The sales taxes vary over provinces in their rate structures and exemptions. Most exempt a group of necessity goods and, significantly, services of most types. Housing sales as well as repairs are generally excluded. Building materials are generally taxable except there are exemptions or rebates where used in hospitals, schools, churches and other public institutions. As with the FST, PSTs fall partly on final consumer sales, partly on intermediate business inputs and partly on capital inputs, with the latter two being relatively less important than under the FST. Kuo, McGirr and Poddar estimated that for 1980 37% of PST revenues were collected on business inputs, and of that the construction industry accounted for about 45%. They estimated that the effective PST rate (aggregated over all nine taxing provinces) was 2.46% for residential construction, all of which was due to the indirect tax on inputs. This compared with a commodity-wide average of 3.07%. In addition, owner-occupied housing was estimated to bear a further tax of .36%, and the real estate industry .66%. Again, given that land is excluded, housing appears to be taxed somewhat less than the average for all consumer goods.

Kuo, McGirr and Poddar also estimated the aggregate effective sales tax rate of the FST and the PSTs combined. They found that residential construction faced an effective tax rate of 5.47%, all on indirect inputs. This compared with an average effective tax rate over all commodities of 8.43%. Owner-occupied housing bore an additional .78% and real estate 1.57%.

These results again confirm that housing is taxed somewhat lower than the average of all commodities.

There is one other aspect to the tax treatment of housing under the existing system of sales taxes that is relevant. Effectively, the tax, to the extent that it applies at all, applies only on new housing. In that sense, the tax is prepaid once and for all. Thus, rate changes to the FST or PSTs do not impact on consumer services from housing that already exists when the change is made. This, of course, is true of personal taxation as well. The personal and sales tax rates applying on housing are those which exist when the house is first acquired.

The existing FST is well-known to have several disadvantages and these are fully documented in the White Paper. A brief review of them will be presented here.

i. The Base is Too Narrow

Since the FST applies only on manufactured goods, it excludes all services as well as all valued added accruing at production stages beyond the manufacturing level. This narrow base is highly distortionary and requires correspondingly higher rates to raise a given amount of revenue. PSTs suffer from this to a lesser extent, since they encompass value added up to the retail level. However, they too exclude services from the base so are not fully general.

ii. The Tax Distorts Production and Distribution Decisions

An implication of the narrow base is that it distorts production in favour of lesser taxed commodities at the expense of more highly taxed ones. Both the FST and the PSTs suffer from this problem. The FST, in addition, distorts the distribution decision since it,

unlike the PSTs, applies at an earlier stage than that at which final sales are made. It favours those manufacturers that are able to shift some costs (e.g., marketing costs, advertising, product development, etc.) to post-manufacturing stages of production. This can particularly done by vertically-integrated firms. The result is a distortion of the system of production and distribution.

iii. The FST has Widely Differing Effects on Final Prices

The effect of the tax on the final selling price depends upon the indirect way in which the tax at the manufacturing level impinges on final production costs through its effect on intermediate and capital inputs. The study by Kuo, McGirr and Poddar confirmed the very wide dispersion of effective FST rates on different consumer goods, ranging from zero up to 9.66%. As mentioned, this serves to distort the pattern of production in the economy thereby reducing its efficiency. PSTs suffer from a similsr, though less pronounced, problem.

iv. The FST Impedes Exports and Increases the Cost of Investment

A substantial proportion of FST collections fall on intermediate inputs and capital goods (both machinery and structures) either directly or indirectly. This also occurs to a lesser degree under the PSTs. To the extent that they fall on the latter, they constitute a tax on investment rather than consumption and thereby interfere with the growth of the economy. The tax on intermediate inputs and capital goods poses particular problems for exported goods. Under a destination system, all taxes levied on exports should be rebated, but this is difficult to do except for direct tax liabilities on final sales. Those exported goods which bear relatively high effective indirect tax rates are put at a competitive disadvantage. The consequence is that the pattern of exports is distorted away from that which would be

dictated by the true comparative advantage that the country possesses and an efficiency loss results. It is important to note that these indirect taxes on imports does not put the economy at an export disadvantage in any absolute sense (contrary to what may be implied by the White Paper). For example, if all exports faced the same tax, the exchange rate would presumably adjust to compensate for that. Instead, what is distorted is the pattern of exports.

v. The FST Treats Imports Preferentially

A related phenomenon applies on the import side. Imports are taxed at their value at the border (gross of duty). Any transportation, distribution or marketing costs subsequently incurred are tax exempt. To the extent that these costs are borne by competing domestic manufacturers, the latter are put at a competitive disadvantage. The result will be a distortion in the pattern of importing (not necessarily the absolute level) in favour of those advantaged imported goods, and an efficiency loss to the economy. Of course, this effect will to some extent be offset by the effect of tariffs on the price of imported goods.

vi. The FST is Unfair to Lower Income Canadians

The White Paper reports that the FST in itself is unfair because as a proportion of income the lower income groups bear a disproportionate share of the tax. It is also claimed that credits delivered through the income tax system rather than exemptions of necessity goods is fairer. In our view, this is a misleading perspective. What is relevant is the progressivity of the tax system taken as a whole. With or without exemptions in the FST, a comparable amount of overall progressivity by income group can be achieved by appropriate choice of a rate structure for the personal tax. The decision as to whether or not to allow

exemptions for particular goods must be based on the additional administrative costs involved along with the equity advantages of allowing progressivity to be defined partly by the components of the taxpayer's budget, and not by the degree of income progressivity that can be achieved by exemptions. The fact is that the ability to allow exemptions increases rather than decreases the degrees of freedom of the government in choosing an equitable tax system. Furthermore, the broader the base of the sales tax, the more freedom does the government have in this regard.

vii. The FST is Too Complex

The White Paper documents convincingly the problems involved in administering the present FST. These arise from difficulties in distinguishing taxed from untaxed goods, the requirement to define notional values, the complexities arising from the differentiated rate structure, and the compliance costs imposed on businesses, especially small ones.

viii. The FST is an Unstable Tax

Finally, the White Paper points out how the complexity of the tax has led to an increasing amount of litigation. Court decisions can have far-reaching consequences which affect the size of the base and the amount of tax collected. This problem supports the case for a tax with a much more general and well-defined base.

For all these reasons, the federal government proposes in the White Paper to replace the FST with a general sales tax with a broader base. The replacement recommended would be a multi-stage tax applying on a destination base on consumption goods up to the retail level. Such a tax, if broadly applied, would avoid most of the above problems with the existing

manufacturing level sales tax. A full discussion of how this is done may be found in Chapter 3 of the White Paper.

Three options are proposed for consideration. The remainder of this section outlines the three options and their treatment of housing.

i. The National Sales Tax

The first option is to replace both the FST and the PSTs for participating provinces with a single multi-stage tax referred to as the National Sales Tax (NST). The NST would involve a sort of Tax Collection Agreement between the federal government and the participating provinces analogous to those that now exist for personal and corporation income taxes. Both levels would have to agree to a common tax base, including presumably a list of tax exempt and tax free (i.e., zero rated) goods and activities. As well, provision would have to be made for future changes in the base. That may well differ from the mechanism inherent in the income tax collection agreements, which basically involves unilateral base change decisions by the federal government alone. The provinces and federal government would be able to choose their own tax rates, though presumably some negotiation would be involved in this as well since the choice of the federal tax rate has a predominant influence on the division of tax room between the two levels of government. There would only be one tax collection authority, presumably the federal government. A rule for allocating tax revenues among provinces would also be required. The White Paper has suggested using the destination principle for provincial taxes, the system which is currently in use for PSTs. This requires the administrative complexities of tracking exports and imports across provincial boundaries on final sales to consumers which is a nontrivial matter. It would seem to be much simpler to use the origin principle for applying provincial taxes, but that seems to have been dismissed

out of hand. Under the origin principle, the same tax rate applies on all sales from a given firm regardless of whether they have been sold within the province or outside its borders.

The existence of differential provincial rates implies that records must be kept of taxes paid on intermediate purchases. This requires that the credit or invoice method be used. This method imposes additional bookeeping costs on those taxpayers within the tax system. But, it has the advantage that particular goods or types of activities can be tax exempt or tax free. The federal government would apparently prefer to keep the use of zero rating for distributional purposes to a minimum and to deliver redistribution through credits under the income tax system. This simplifies the tax system, although as mentioned the equity advantages have been overstated in the White Paper.

ii. The Federal Goods and Services Tax

If the federal government institutes its own sales tax system separately from those that exist at the provincial level, one option would be for the tax to be based on the subtraction method. This is referred to in the White Paper as the Goods and Services Tax (GST). It would require that the base be very comprehensive with few exemptions or zero-rated goods since the system uses no invoices. As discussed earlier, the subtraction method simply involves applying the tax to the difference between revenues and taxed inputs. This has certain administrative advantages since the self-assessment procedure basically uses information that most firms will already be recording in their account books. It also minimizes the complications of jointly complying with the federal and provincial sales taxes. On the other hand, its use basically precludes the widespread use of exemptions and differential rates, both of which are widely used in multi-stage tax systems throughout the rest of the world for a variety of reasons (including equity, administrative simplicity, etc.). Note, however, that zero-

rating is straightforward under the subtraction method used for the GST. For a zero-rated commodity, the sale of the commodity would be untaxed, but inputs would still be deductible from the base. If the commodity were to used as an intermediate input in further production processes, it would be treated as a deductible input cost. This would be relevant for housing if one wished to zero rate housing to remove its full value from the tax altogether as has been done, for example, in the U.K.

iii. The Federal Value-Added Tax

The other option for a federal-only multi-stage tax is to use the credit method. This is referred to as the federal Value-Added Tax (VAT). This is the standard method used in Europe and elsewhere. As discussed earlier, it involves applying the appropriate tax rate on sales within the taxed sector and providing a credit based on taxes having been paid on purchased inputs, as recorded on invoices. Although this involves additional paperwork on behalf of the taxpayer, it has the advantages that exemptions and differential rates (including zero) are readily accomodated and self-policing is induced.

The White Paper outlines in some detail how a multi-stage tax might apply to various sectors. The tax treatment of housing recommended is basically the same under each of the three options (this despite the fact that under the NST option the provinces and federal government must somehow negotiate a common base). The tax will apply fully on the sale of newly-constructed residential housing (including land) whether that sale be for owner occupancy or for rental. It also applies to maintenance expenditures and improvements. Subsequent rental or imputed rents are tax exempt. This implies that all new housing, maintenance and improvements are taxed on a prepaid basis at the rates applying when the

cash outlays are made. Note that full prepayment of the tax applies regardless of the amount of equity ownership in the house, or, conversely. the size of the mortgage.

Note that if the provinces agree to an NST as outlined in the White Paper and it is implemented, both the federal and provincial sales taxes will apply fully to sales of new housing. On the other hand, under either of the purely federal options (GST and VAT), only the federal sales tax will apply to new housing. Provincial sales taxes, which are not levied on the sales of new houses (but may apply on inputs into housing construction to some extent), will presumably remain as they are now. Thus, the effect of the sales tax reform on housing as discussed below will be correspondingly lessened

In addition to rentals being exempt, sales of used houses are exempt. This is at variance with the sale of other types of used goods, and has several important implications. Sales of other used goods are taxable if they are either sold by taxpaying firms or if they are sold to taxpaying firms (or both). Thus, a used good sold by a taxpayer is liable for tax on the sale value, with a credit being given for any tax earlier paid. These goods are fully taxable. A used good sold by a private individual (or tax-exempt institution) to another private individual remains outside the tax net. However, a used good sold by a private individual to a taxpaying firm re-enters the tax net. Its sale value is not taxed, but the purchasing firm obtains a notional input tax credit at the existing tax rate except in the case of an "appreciating" used good (e.g., works of art, jewellery, etc.).

For used housing, none of these provisions apply. Sales of used housing by either private individuals or taxpayers, whether to taxpayers or not, are tax exempt. This implies that the future consumption services on all residential housing that existed at the time the tax in introduced goes untaxed, or, more accurately, bears only the tax that existed before the new tax was introduced. To the extent that the new tax imposes a higher rate on

housing consumption, this represents a tax advantage on old housing. Furthermore, the exemption of all used housing sales also implies that future tax changes will only apply on housing constructed after the tax change is introduced. And, any unexpected capital gains on housing go untaxed. Presumably, one would like to tax capital gains on housing whether they reflect a change in the relative value of imputed rents (or consumption services), or a change in the sale value of the house due to interest rate changes. Note that these provisions apply on all real estate held by private individuals, whether a principal residence or not.

It might be noted here that treating used housing sales on a par with the sale of used goods as outlined in the White Paper will not avoid all these problems, either. If the sale takes place outside the taxed sector (i.e., from one private individual to another), an old house does not enter the tax net and is not subject to the tax. Also, if a house which existed at the time of the introduction of the tax is sold from a private individual to a taxpaying firm, the firm would be liable to claim a notional credit even though the house will not have paid a tax in the past. Thus, housing in existence when the tax is introduced would never bear the new tax. The same problem applies to housing in existence when any future tax rate change is introduced.

There are, in addition, some purely administrative difficulties involved in the exemption of rentals and used housing sales. They apply only on housing used for residential purposes. Non-residential housing services are fully within the tax net, including housing rental to individuals for short periods (i.e., hotel rooms and short-term rentals of less than 30 days). Some housing is used jointly for residential and non-residential purposes, such as apartment buildings or private homes used partly for business purposes. Private housing used primarily as a residence will be tax exempt. Those used primarily for taxable activities will be taxed

and credited for taxed inputs on a prorated basis. Similarly, rental accomodations used partly for business purposes will be taxed and credited for taxed inputs on a pro-rated basis.

These various difficulties will be returned to later when we consider problems with the White Paper proposals in Section VI and alternatives in Section VII.

The sales tax reform proposals represent the second phase of a broader tax reform package. The first phase introduces certain changes to the personal and corporate tax systems each of which affects housing to a certain extent. The personal tax reform broadens the personal tax base and lowers the rates. This has certain implications for housing which might be borne in mind in assessing the effects of the sales tax proposals. A full assessment of the tax reform package as a whole may be found in Fallis, G. and Smith, L., "The Treatment of Real Estate under the Tax Reform", in J. Mintz and J. Whalley (eds.), The Economic Impact of the 1987 Tax Reform, Canadian Tax Foundation, Toronto, 1988. Only the cursory treatment is presented here, with a more detailed discussion in Section V below.

Since the personal tax system already taxes housing on a prepaid basis, the reduction in personal tax rates will directly offset the increase in sales tax rates imposed on housing. Thus, the net effect of the sales tax imposition on housing will be less than the increase in the effective sales tax rate on housing taken on its own. Also, the reduction in personal rates reduces the distortion imposed by the personal tax on tenure choice. That is, it makes the tax advantage of owner occupied housing over other assets less pronounced.

Corporate tax changes affect the housing industry in offsetting ways. On the one hand, the lowering of the rate structure assists all industries, housing included. At the same time, some of the base broadening measures apply specifically to housing. One of these is the

requirement of land developers to capitalize the soft costs of holding and developing land. The other is the institution of put-in-use rules for depreciating capital goods. Fallis and Smith [1988] judge that overall these changes will have little impact on housing supplies.

V. The Impact of the Proposals on the Housing Market.

The White Paper proposals will raise the effective sales tax rate on the consumption services derived from new residential housing. The rise in the effective tax rate occurs because the multi-stage Federal Sales Tax will apply to land, construction value-added and realtor value-added in addition to the building materials which are currently taxed under the federal and provincial sales taxes. The increase in the effective sales tax rate on housing depends on the share of these previously excluded elements of housing costs, on whether the provincial tax rates will apply to them as in the case of the national sales tax option, and on the rate at which the sales taxes are imposed. Even if the tax were applied at the federal level only and at the current rate applying to building materials (8%), the effective tax rate on housing will rise substantially relative to most other commodities. The presently excluded elements of value-added in housing constitute at least one half of the total so this alone would double the effective tax rate on housing. Also, the present 8% tax on building materials is a preferential rate with the full rate being 12%. It is expected that the full rate will decline as a consequence of broadening the sales tax base. Thus, under the proposed reforms the effective tax rate will decline for commodities subject to the full FST rate.

We analyze the impact of an increase in the effective tax rate on residential housing using a stock-flow supply and demand model. In Figure V.1 we show the supply and demand for the stock of housing in the right-hand panel and the supply and demand for residential construction in the left-hand panel. On the vertical axis we measure the purchase price relative to other goods of a standardized unit of housing. On the right-hand horizontal axis we measure the stock of standardized housing units per capita and on the left-hand horizontal axis we measure construction of standardized units per capita. At a point in time the

population size is fixed but the population grows over time which, along with depreciation, gives rise to the demand for residential construction.

The downward sloping curve labelled D represents the demand curve for housing stock per capita or, for short, the stock housing demand curve. As the price of a unit of standardized housing falls, a larger stock is demanded per capita. At any point in time the stock of housing available per capita is fixed. If the housing market is competitive and we ignore imperfections such as rent controls in the rental part of the housing market, the equilibrium price of a standardized housing unit is found from the housing stock demand curve. For example, the equilibrium price of the housing stock H_1 is P_1.

In the left-hand panel, the upward-sloping curve denoted s represents the supply of residential construction per capita. Residential construction includes new housing, improvements and maintenance. The supply of residential construction rises as the relative price of housing rises, ceteris paribus. The higher relative price of housing attracts resources including land, capital and labour into the production of residential housing. The supply curve s is drawn for the pre-reform tax regime. In the same panel the downward sloping curve labelled d represents the equilibrium demand for residential construction. Corresponding to every price level on the vertical axis is an equilibrium stock of housing given by the stock demand curve D. Multiplying the stock demand at any given price by the growth rate plus the physical depreciation rate of housing yields the level of residential construction which is necessary to maintain the housing stock per capita at that price. This gives the curve labelled d in the left-hand panel.

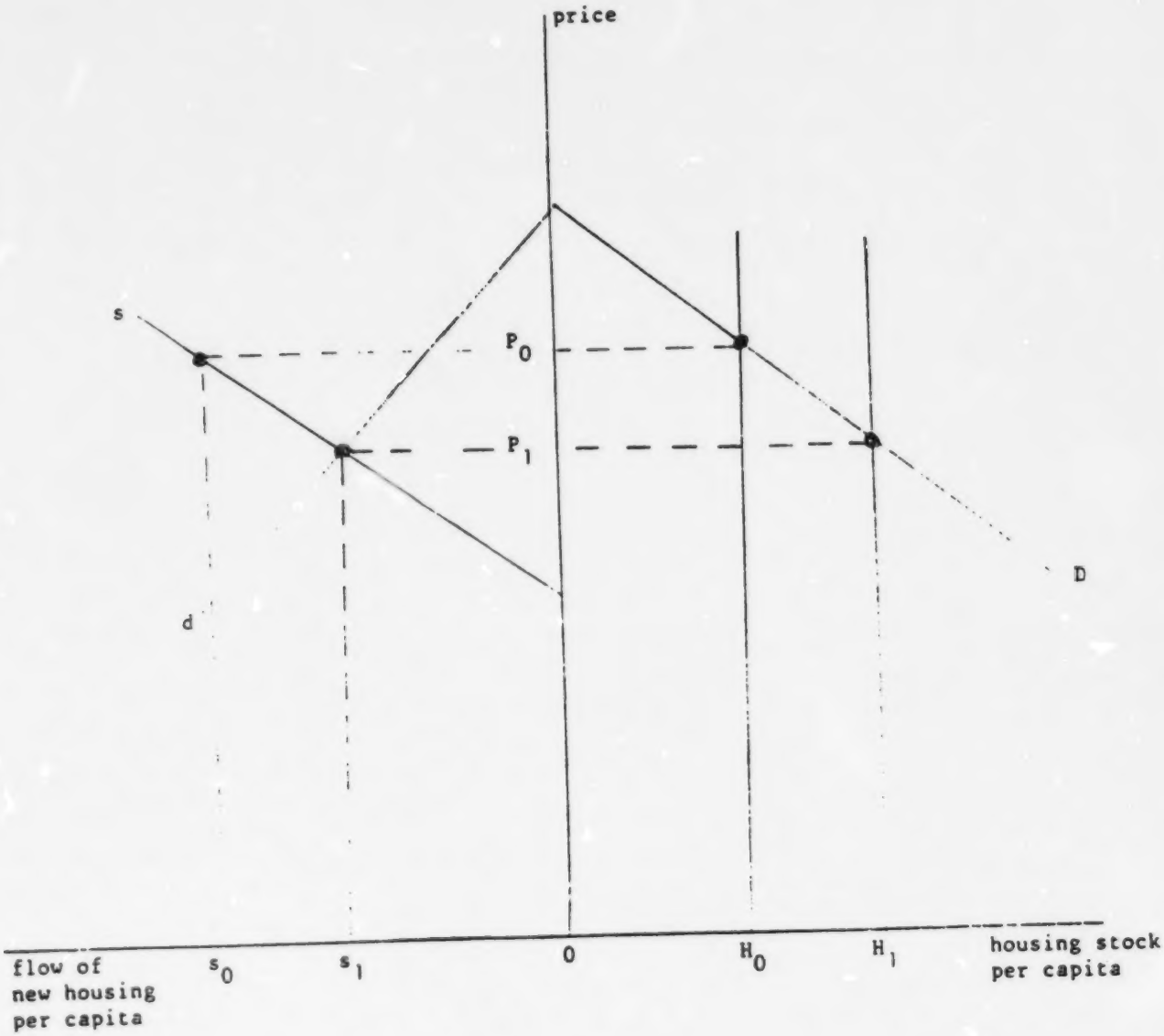
price
s
P_0
P_1
D
d
flow of
new housing
per capita
s_0
s_1
0
H_0
H_1
housing stock
per capita

Figure V.1

The stock-flow dynamics of the housing market operates as follows[2]. Suppose at the present time the existing housing stock per capita is H_0 (which is less than the equilibrium stock H_1) and, in order to clear the market for the stock of housing, the price of housing is equal to P_0. At P_0 the supply of residential construction is equal to s_0 which is greater than s_1, the level needed to maintain the existing stock of housing. Thus the housing stock per capita rises. As the housing stock rises, the relative price of housing falls and construction falls until the housing stock and price reach H_1 and P_1 respectively. At that price, construction activity proceeds at a rate s_1 which is just needed to maintain the housing stock per capita. The housing market is said to be in both stock and flow equilibrium.

i. The General Impact of an Increase in the Tax on New Housing.

We now analyze the impact of an increase in the effective tax rate on the construction and sale of new housing. This is the expected result of the proposed reforms of the sales tax. Note also that the pending reforms in the corporate and personal taxation of income from housing construction and development activities probably reinforce this increase[3]. We consider first the case where there is no speculative demand for housing created by the rising housing prices caused by the increase in the effective tax rate. In Figure V.2 the higher effective tax on the construction and sale of residential housing shifts the supply curve upwards to s^t where the vertical distance between s and s^t is the increased tax on new residential housing. A higher price of housing is now needed to call forth the same level of construction activity because of the increased tax. For example, under the proposed sales tax

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[2]In this exercise we exclude speculative demand for the housing stock based on anticipated changes in housing prices. The effect of speculative demand is discussed below.

[3]The elimination of various tax preferences such as the immediate expensing of soft costs is likely to more than offset the reduction of statutory corporate and personal tax rates.

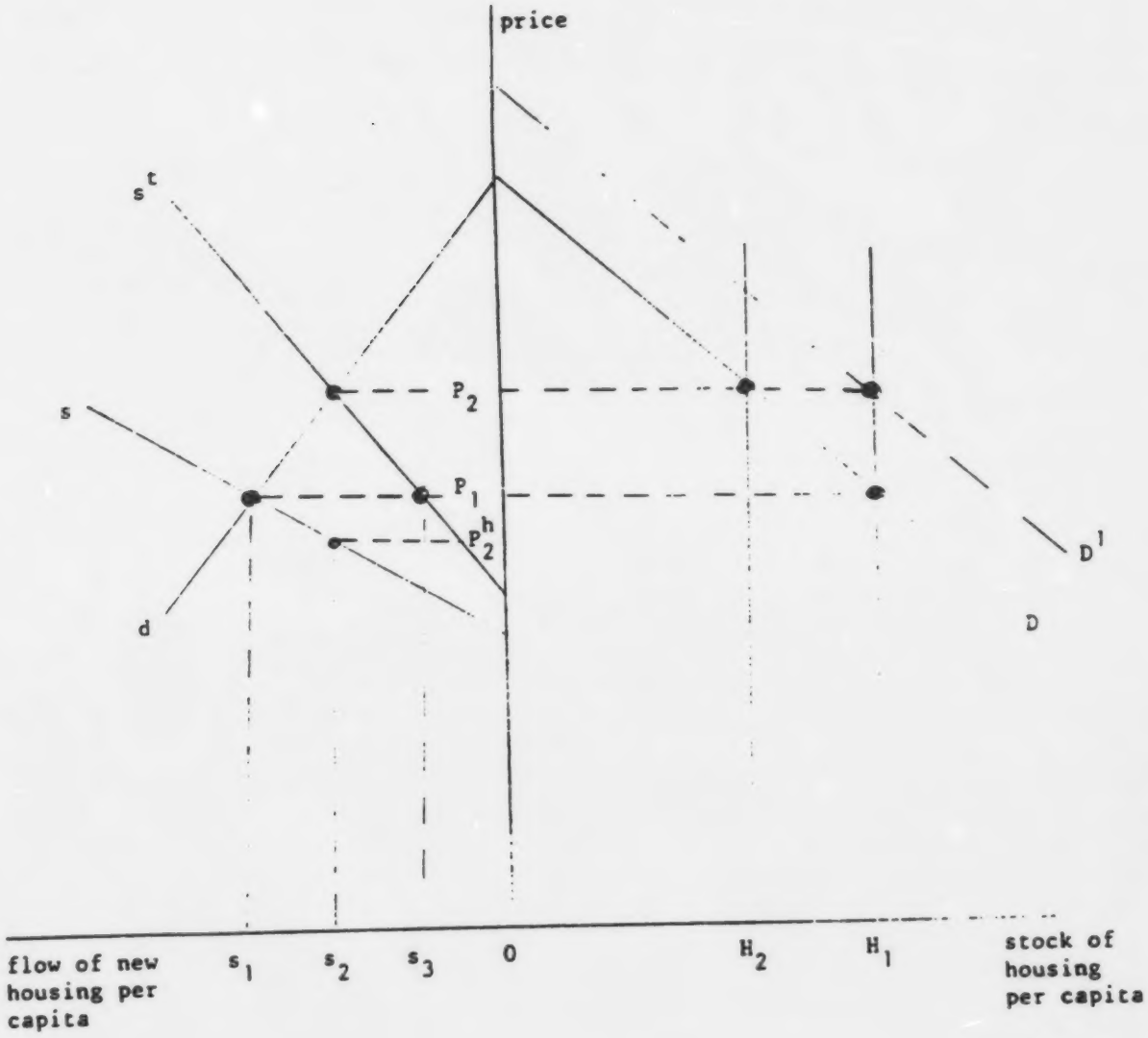
price
s^t
s
P_2
P_1
P_2^h
d
D^1
D
flow of new housing per capita
s_1
s_2
s_3
0
H_2
H_1
stock of housing per capita

Figure V.2

reforms, the developers will pay tax on the entire value of house including land, construction value-added and realtor's services instead of just the building materials. At any given price for housing, less resources will be attracted into housing construction and development. Equivalently, the developer will have to "pass on" the increase in taxes to the final purchaser at each level of construction activity.

The short-run impact of the increase in the effective tax rate on housing is to reduce construction activity from s_1 to s_3. At this level, the housing stock per capita will begin to fall and housing prices will begin to rise. Construction activity will also rise but will not return to its pre-tax level. Stock-flow equilibrium will be restored when housing prices rise to P_2. At this price, construction activity is s_1 which is exactly that needed to maintain the equilibrium housing stock H_2. The new equilibrium housing stock is smaller because the increase in the tax rate causes people to economize on housing. The net-of-tax price of housing received by developers falls to P_2^n. Note that because of the upward sloping supply of construction, housing prices will rise by less than the increase in the effective tax imposed on housing.

In the above scenario, housing prices adjusted slowly to the increased tax on new housing. In fact, housing prices might adjust rapidly because of speculative demand for housing. Because the short-run impact of the tax reduces housing construction below that needed to maintain the housing stock per capita, speculators anticipate that housing prices will rise and purchase housing immediately in order to receive a capital gain. For example, speculative demand might shift the stock demand curve temporarily to D^1 so housing prices jump immediately to P_2. In this case, construction activity falls to the new long-run equilibrium level s_2 immediately rather than falling by more as in the case where speculative demand is ignored. This is still less than needed to maintain the housing stock at H_1 so the

housing stock gradually declines. However, speculative demand also falls so prices do not rise above the long-run equilibrium level of P_2. The long-run equilibrium is the same as in the case where speculative demand is absent. The only difference is that housing prices adjust to the new higher long-run equilibrium level immediately, and construction activity does not decline as much in the short-run as a result of the increase in the tax.

To summarize, the increase in the effective tax rate on new housing resulting from the proposed sales tax reforms will, in the long-run, increase the price of housing and reduce the stock of housing per capita, ceteris paribus. The rise in housing prices will be less than the rise in the effective tax rate because some part of the tax will be shifted back to landowners and factors of production. Correspondingly, the level of residential construction activity will also fall. The short-run impact of the tax increase will depend on the amount of speculative demand created by the tax changes. In the absence of speculative demand, housing prices will rise slowly but construction activity will be severely depressed in the short-run. With speculative demand, housing prices will jump immediately and residential construction activity will decline only to the new long-run equilibrium level.

The above analysis outlines the general impact of the increase in the effective tax rate on the housing market as a whole. We now discuss some particular impacts including the type of housing (single versus multiple dwellings), rental versus ownership, and regional differences.

ii. The Impact on the Housing Industry.

There are several dimensions to the housing industry. They include the development of land tracts, the construction of single- and multiple-dwelling units, and the maintenance and renovation of existing dwellings. In addition there are the related services including those of

the real estate agents and the mortgage bankers. The housing market is distinquished by the importance of the second-hand market and the potential for self-supply. The latter refers to the possibility that home owners can by-pass the market, and hence taxes, by providing their own services. This occurs when a person constructs, renovates or decorates her own home. It also occurs when a person sells her own home rather than going through a realtor.

A general impact of the proposed changes will be to encourage self-supply by persons outside the tax net. Self-supply rules will apply to those inside the tax net. For example, if a developer constructs a dwelling and then leases it, he will be taxed as if the dwelling were sold at fair market value. However, persons outside the tax system will have an incentive to do their own decorating, renovating, etc. This may involve hiring casual labour from other persons outside the sales tax system for these purposes. There is also an incentive for persons to privately sell their existing homes rather than use a realtor because the services of the latter will be taxed even if the sale of the home itself is exempt. For similar reasons there will be an incentive for home sellers to take back mortgages in order to avoid the sales tax on the intermediation services of mortgage bankers. It should be noted that these incentives already exist to a certain degree under the personal income tax. The proposed sales tax changes will simply reinforce them.

The proposed changes will have an effect on the type of housing produced. This occurs because different types of housing have different shares in total value coming from materials, which are already taxed, and the value of land, labour, capital and realtor's services which will become taxed. In general, the tax changes will cause developers to economize on the previously untaxed components in the value of a house. Thus we expect that housing will become more materials intensive and, especially, less land intensive.

Single-dwelling housing is usually more land intensive and less materials intensive than multiple dwelling housing. For this reason, the proposed taxed changes are likely to raise the effective tax rate on new single-dwelling housing more than for multiple-dwelling housing. Consequently, the prices of single-dwelling housing will rise by more and construction of this type will fall by more unless the tax on the land component is mostly shifted back to the land-owners.

In addition realtor's services will be taxed under the proposals so housing that is more likely use the service of realtor when sold will be harder hit by the tax changes. Realtor's services are more likely to be used for selling multiple dwelling housing and selling housing in some markets (e.g, luxury housing is more likely to be sold through a realtor).

The proposed tax changes will encourage materials intensive housing and discourage other forms of value added in comparison to the pre-reform situation. For example, pre-fabricated housing is presently taxed more heavily than construction because the sales tax applies to the entire value of the pre-fab house (except assembly). This bias will be removed by the proposed reforms.

iii. <u>The Impact on Tenure Choice.</u>

The proposed changes are nominally neutral with respect to tenure choice. New housing, whether owned or rented, will be subject to the same tax rate. In both cases, the tax on housing services is "prepaid" with the tax on the value of the new dwelling. Both imputed and market rents are exempt from the sales tax. Of course the existing income tax continues to favour ownership since imputed rents are exempt whereas market rents are taxed. To the

extent that the reforms increase sales tax revenues in order to reduce income tax rates (for example, to remove the existing surtax), the bias in favour of ownership is reduced.

There may be secondary effects on tenure choice, however. The most important of these will involve constraints that households face in obtaining mortgage finance. As noted above, the income tax system favours ownership over rentals. One reason many people rent in spite of this tax incentive is that they are liquidity constrained and cannot raise the required down payment on an owner-occupied dwelling. Generally, the down payment is some fraction of the price of the house. Since house prices will rise as a result of the proposed changes, a larger down payment will be required and one can expect more potential own home-buyers to be liquidity constrained. For this reason, the proposed changes may shift tenure choice towards rentals for households with few financial assets.

In addition, as mentioned, the proposed changes may favour multiple-dwellings over single[4]. If the former are more amenable to rental than the latter, rentals may be encouraged. On the other hand, the interaction of the tax changes with rent controls may discourage rentals. Under existing rent control legislation (Ontario), rental rates can be freely set on new dwellings. Thus, sales taxes paid on construction can be passed on to the tenants. However, in order to recover sales taxes paid on the maintenance and improvement of existing buildings, landlords would have to go through a rent review process to raise rents (unless legislation for an automatic increase is introduced). To the extent that such a process is costly or rent increases are denied, the increased tax rate may discourage the supply of rental housing. In view of the already severe impact of rent controls on the supply of rental housing, this is likely to be a major issue.

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[4]However, corporate tax changes may offset this advantage. Multiple unit dwellings are more likely to be constructed by corporate firms and operated in corporate form, and the pending corporate tax changes may raise the effective tax rate applying.

iv. Regional Impacts.

The impact of the proposed sales tax changes across regions may vary because the tax rate varies across the provinces (if the national sales tax option is adopted) and because of differences in the supply and demand situation by region. In a region where little or no residential construction activity is occuring because of slow growth and high vacancy rates, the impact of an increase in the effective tax rate on new housing is expected to be small. On the other hand, in a rapidly growing region with low vacancy rates, residential construction will be high and the impact of the tax changes should be greater. The impact on housing prices is less obvious.

We analyze the impact of the changes in high and slow growth regions in Figure V.3. We assume the demand curve for the stock of housing per capita in the right-hand panel and the residential construction supply curve in the left-hand panel are identical for both the high growth and slow growth region. However, the level of construction that is consistent with long-run equilibrium at a given price of housing is greater in the high growth region because more construction is needed to maintain the housing stock per capita[5]. Thus, d^h lies to the right of d^s in the left-hand panel. The long-run stock-flow equilibrium in the high growth region involves a higher price of housing P_h, a higher level of construction s_h and a lower stock of housing per capita H_h than for the slow growth region where the housing price, construction level and stock of housing per capita are given by P_s, s_s and H_s respectively.

[5]Alternatively, the "high" region could be one with an older housing stock which is depreciating more rapidly so more construction is needed to replace the worn out housing.

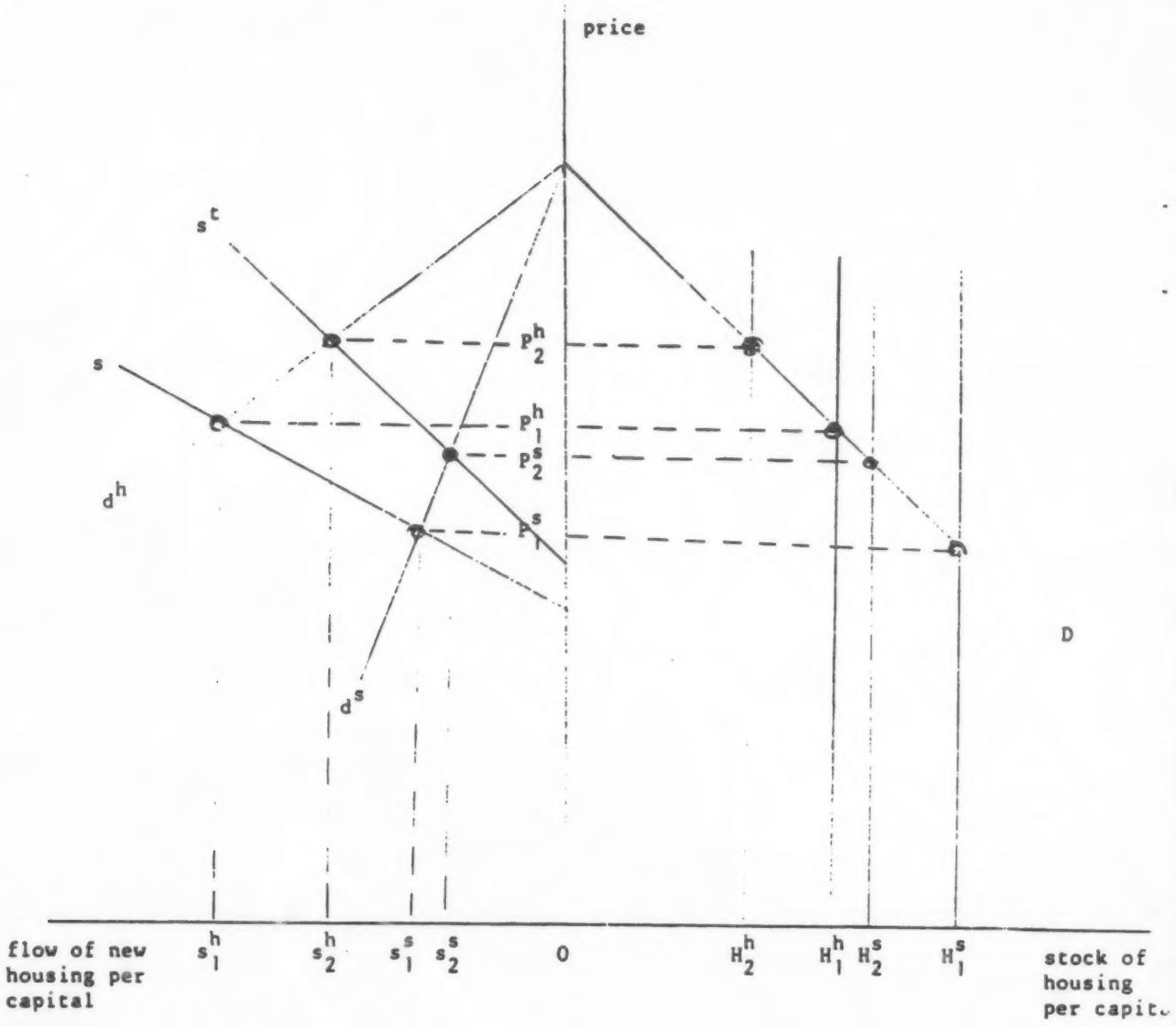
price
s^t
s
d^h
d^s
P_2^h
P_1^h
P_2^s
P_1^s
D
flow of new housing per capital
s_1^h
s_2^h
s_1^s
s_2^s
0
H_2^h
H_1^h
H_2^s
H_1^s
stock of housing per capit.

Figure V.3

The proposed tax changes shift the residential construction supply curve to s^1 in both regions assuming the effective tax rates change by the same amount in both regions. Housing prices rise, housing stocks and residential construction activities fall in both regions. Construction activity falls by more (in absolute terms) in the high growth region. It can also be shown that housing prices are likely to increase by a smaller percentage in the high growth region as compared to the low growth region providing the per capita housing demand curves are the same for both regions[6]. In fact, the per capita housing demand is likely to be greater in the high growth region because of higher income and the percentage change in housing prices may be greater or smaller.

It should be added that the slow growth Maritime regions in Canada also have higher provincial sales tax rates. If the National Sales Tax option is adopted with the changes proposed for housing, the effective tax on housing construction will rise by more in these regions than in low or zero provincial sales tax regions, such as Alberta. In this case, it is likely that housing will be much more discouraged in the slow growth regions (unless there is no residential construction activity at all in the region).

v. Distributional Impacts.

The proposed changes will have important distributional impacts. The most important distributional impact will be between owners of existing housing and new entrants into the housing market. In addition, the changes will have different distributional impacts across

[6]In this case it can be shown that the percentage change in the equilibrium price is equal to the percentage change in one plus the effective tax rate times the ratio of the supply elasticity to the sum of the supply and (absolute) demand elasticities. If the housing stock demand and construction supply curves are the same and linear in both regions, the ratio must be smaller in the high growth region.

income classes although this can be offset, as the Federal government promises to do, with a sales tax credit.

In order to analyze the distributional impact of the proposed changes we return to figure V.2. In this figure we saw that the price of housing rises as a result of the proposed changes but, generally, by less than the increase in the tax rate except in the case where the supply of residential construction is perfectly elastic. It can be shown that the percentage increase in the price of housing in long-run, stock-flow equilibrium is equal to a fraction x of the percentage change in one plus the effective tax rate where x is the ratio of the elasticity of the residential construction supply curve (that is, the percentage change in residential construction induced by a one percentage point change in the price of housing, ceteris paribus) to the sum of the elasticity of the residential construction supply curve and the (absolute) elasticity of the housing stock demand curve (that is, the negative of the percentage change in stock of housing induced by a one percentage point change in the price of housing).

If the residential construction supply curve is perfectly elastic (that is, horizontal in figure V.2), $x = 1$ and housing prices rise proportionally with one plus the effective tax rate. In this case, the entire tax increase is passed on to the consumer of the housing services. More generally, x is a proper fraction and housing prices rise less than proportionally to the rise in one plus the effective tax rate. In this case, some part of the tax is passed back to the owners of factors of production used in the supply of new housing. The factors of production most likely to bear the increase in the tax are those that were previously untaxed (land and value-added in construction) and those that are inelastically supplied to the residential construction industry (that is, have few alternative uses). For these reasons,

owners of unimproved land on the margin of residential use are most likely to bear the backward shifted part of the tax.

To the extent that the increased tax is forward shifted in higher housing prices, there will be a sizeable transfer from those entering the housing market to those leaving it (retiring households and those leaving the country). Transfers may also be created between those moving among regions. In figure V.2 we saw that the price of all housing, existing and new, will be increased by the tax. If a new house cost more because of the forward shifted sales tax, then owners of existing houses will be able to sell their homes for that much more. In effect, the tax on new housing creates a tax on all housing services but the "revenues" on existing housing accrue to the owners, who realize them as capital gains when the house is sold. Since new housing is a small fraction of existing housing at any point in time, the initial transfer to owners of existing housing may far exceed the additional government revenues collected on the new housing.

Two things should be noted about this transfer. First since owners of existing housing tend to be older, it involves a transfer from younger to older generations. This exacerbates the generational transfer from the young to old that is presently occuring because of large government deficits and unfunded public pension plans. Second, the transfer is larger the greater the value of the existing house. Thus the transfer is generally from the poorer (the young and renters) to the richer. To the extent that some of the tax increase is shifted back to owners of unimproved land, this distributional effect is likely to be mitigated if the owners of unimproved land are richer on average.

While we have spoke of the transfer going to the owners of existing dwellings, it should be noted that tenants in existing dwellings may enjoy the benefits rather than the owners in

rent controlled regions. Since there is no tax on the services provided by existing dwellings, landlords of existing rental housing will have no basis for raising their rents under rent controls even though rents in new dwellings may increase because of the tax changes. Essentially, existing tenants will continue to enjoy housing services at rental rates that prevailed before the tax changes. In contrast, landlords will be able raise rents on dwellings in existing buildings in areas where there are no rent controls because of the rise in rents on new rental housing that is subject to the tax. In effect, there will be a transfer from the tenants to the landlords of existing, uncontrolled rental housing.

The distributional impact across income classes is less obvious. One thing is certain and that is that the share of income spent on principal accommodation declines sharply with income. In Table V.1 we report the share of various components of housing expenditures by income class in 1982 as reported in the Family Expenditure Survey. As can be seen from this table, the lowest income decile spends nearly a third of its income on housing whereas the highest income decile spends under 15%. However, as shown in Table 2.4 of the White Paper on the proposed sales tax reforms, the top half of the income distribution still accounts for a larger share (nearly two-thirds) of total spending on shelter and utilities. Lower income groups spend a larger share of their incomes but higher income groups spend more.

While it might be expected that an increase in the taxation of housing will be highly regressive with the burden falling more heavily (relatively) on groups with low ability to pay, there are several caveats to keep in mind before drawing such a conclusion. Some of these have been noted by Davies [1985]. First, it is assumed that the increased tax on housing will be forward shifted to the consumers of housing services rather than backward shifted to landowners and the owners of factors of production specialized in housing construction. While some degree of backward shifting will no doubt occur, it is likely that that will be substantial

Table V.1

1982 Housing Expenditures as a Share of Income (%)

Income Class	Rent Plus Ownership Exp.	Total Shelter (Incl. Utilities and other)
less than 7,000	24.8	32.4
7,000 - 9,999	21.3	27.8
- 14,999	17.3	23.8
- 19,999	15.6	20.5
- 24,999	14.3	18.7
- 29,999	13.9	18.3
- 34,999	13.2	17.3
- 39,999	12.2	16.5
- 49,999	11.9	16.0
above 50,000	10.0	14.0
All	13.0	17.5

Source: Family Expenditure in Canada, 1982
Table 1
Statistics Canada

forward shifting. Second, many households are temporarily located in particular income classes. This makes the share of expenditure on housing decline with income so sharply. For example, a person whose income is temporarily low because of a lay-off or illness does not sell his or her house and move into cheaper accommodation and neither does a person who has a "good year" because of overtime or a special bonus run out and buy a more expensive house. If one looks at the pattern of housing spending on the basis of a longer-term measure of household income (which is perhaps a better criterion for defining need and ability to pay), the decline in housing expenditure across income classes would not be as apparent. Third, the impact of the increased housing cost may, and likely will, be offset for many low income households. For one thing, the government promises to "substantially enrich" the sales tax credit for low income households. For another, transfers to low income households are indexed to the cost of living. To the extent that the sales tax changes increase the cost of living, households dependent on government transfers will automatically receive higher transfers to compensate. Finally, because the increase in the tax falls on residential construction rather than housing services, low income households who own their own homes will enjoy capital gains on their homes. A significant number of persons in the low income deciles are pensioners who own their own homes. Not only will such persons receive an automatic increase in their government pensions because of a general increase in the cost of living caused by the sales tax changes, they may also receive a capital gain on their home.

The clear-cut losers from the proposed changes will be the young and the poor who do not receive indexed government transfer payments. It is doubtful that the government will enrich the general sales tax credit sufficiently to compensate this group.

VI. Pros and Cons of the White Paper Proposals

The main purpose of this section is to consider the advantages and disadvantages of the way in which it is proposed to treat housing under the multi-stage tax in one of its three variants. As a prelude to doing so, it might be worth briefly considering the broader issue of introducing a multi-stage tax at the federal level in the first place.

There is widespread agreement that the existing FST is a very flawed tax. The reasons are carefully documented in the White Paper. Of primary concern are two general problems. The first is the narrowness of the base. The second is the unintended effect of the tax on business inputs (both intermediate and capital) which serves to distort production and trade patterns in the economy. A sales tax which avoids both these problems is a multi-stage retail tax of the sorts outlined by the White Paper, although it does so at a cost of a varying degree of compliance costs imposed on the private sector depending on the exact details of the system. The federal government has, therefore, opted for replacing the FST with such a tax. If the objective of sales tax reform is accepted to be to find a suitable sales tax replacement at the federal level for the existing FST, this seems to us to be a reasonable course to pursue.

At the same time, however, it should be recognized that on the broader question, there are other alternatives that could have been chosen. Generally speaking, there are two broad issues that need to be determined as well the exact choice of a sales tax. One has to do with the overall tax mix between direct and indirect taxes and the other has to do with the allocation of taxes between the federal and provincial levels of government. Consider the latter first. An option to introducing the federal sales tax which would preserve the direct/indirect mix would be for the federal government to turn over sales tax collections to

the provinces entirely in return for additional income tax room at the federal level (or vice versa). This was the option that had been recommended by the Rowell Sirois Commission in the 1940s. This would avoid the tension that could arise from the perceived federal intrusion into a tax field that has traditionally been occupied by the provinces, and would give the federal government a larger share of the tax room of the base which is most suited to pursuing equity objectives. At the same time, it would avoid the duplications involved in firms having to administer two different levels of sales tax. On the other hand, the potential for achieving greater sales tax harmonization through a common negotiated national sales tax base would be lost. It is unlikely that the provinces would agree to that by themselves, or that any would contemplate introducing a multi-level sale tax on their own.

The other general issue that should be addressed is the implication of the adoption of the multi-level sales tax for the direct/indirect tax mix and in turn for the ability of the government to increase its size. As mentioned earlier, there is no compelling economic reason for having a general sales tax alongside a personal tax system, except, perhaps, to reduce the incentive and ability to evade taxes. There may well be political reasons which have to do with reduced taxpayer resistance (but which rely presumably on taxpayers being under some illusion about the taxes actually being levied on them). This very possibility, however, leads to a problem that is often pointed to by detractors from a general sales tax, and may explain partly why such a tax does not exist in the U.S. That is the fear that the introduction of a general sales tax will make it easier for the government to increase its share of output in the economy. Again, it is very difficult to evaluate this argument on economic grounds.

Those arguments aside, given that a multi-stage retail tax is going to be introduced, and given that it must be broadly-based, the options for dealing with housing are somewhat restricted. In the remainder of this section, we consider the pros and cons of the way in

which it is proposed that housing be treated. In the next section, other alternatives are considered.

It is useful to establish a benchmark against which to judge the proposed system. A natural benchmark to choose is a fully general sales tax in which all final consumer services are taxed at the rate appropriate when the services are consumed. The proposed system varies from that in a number of ways, though it is much closer to it than is the current FST. Virtually all the variation arises from the durability of housing and from the fact that it can either be owned or rented. The main sources of variation with the fully general sales tax system are as follows.

i. Owner-occupied housing is taxed on a prepaid basis when it is acquired, as well as when it is maintained and improved, rather when its services are consumed. This can cause the following anomolies. First, if tax rates change, the services are not taxed at the rate applicable when they are consumed. Second, if unexpected relative price changes occur in housing services (corresponding to capital gains in the value of the house), these go effectively untaxed. Finally, the requirement to pay the full tax up front can exacerbate liquidity problems that might be faced by house purchasers. Though these problems afflict all consumer durable goods, they are relatively more important for housing because of its greater durability and because of its relative importance in consumer budgets.

ii. Rental housing is taxed up to the point of sale to the owner, but rentals are tax-exempt. This has two implications. First, it detracts from generality by excluding any value that has been added at the rental stage. Second, since rental housing is taxed when the housing is acquired by the owner (or when the owner undertakes maintenance or improvements), the tax is effectively prepaid in the hand of the owner and all the problems of prepayment outlined

above under i. are present. Note that the treatment is the same whether the owner is a firm or an individual.

iii. Since only the sale of new housing, maintenance and improvements are taxed, the consumer services of the existing stock of housing go untaxed under the new tax. They bear any tax that has already been prepaid under existing tax systems. This implies that all existing owners of housing, whether owner-occupied or for rental, obtain a windfall gain equal to the present value of the difference between the tax liabilities under the new tax system, and those under the old system. The amount of the difference depends upon the extent to which the new tax substitutes for direct taxes as well as the previous FST. Under the FST, the value of a house itself is taxed at a slightly lower than average rate, taking indirect effects fully into account, but the value of land and real estate are virtually untaxed. Overall, the full value of a house purchase is taxed relatively lightly. Under the personal tax, owner-occupied housing was already treated like other items of consumption, but rental housing was discriminated against. The magnitude of the windfall gain to existing housing owners from introducing the new tax will be lessened to the extent that income tax liabilities on housing fall and to the extent that housing is being taxed under the existing FST.

iv. All used housing sales are excluded from the tax base. This implies that value added attributable to the second hand market in housing is exempt from the tax base, although other used consumer goods are taxed. It also means that an opportunity to correct for changes in tax rates and capital gains as discussed above is lost.

The overall effect of these deviations from the general base is that housing is favoured in the sales tax system, though the extent of the favouritism varies considerably by type of

tax. The main reason for the system to include such advantages is administrative ease. This can be seen by considering each of the above deviations from the general base separately.

Taxing owner-occupied housing services on a prepaid basis is a practical necessity. To tax services directly would require imputing a value to consumer services of owner-occupied housing since no market price exists. This is obviously very difficult to do. Given this, it would be very difficult to account for price changes and unexpected changes in the value of housing services, except to the extent that this can be done when houses change hands. It is also difficult to avoid the liquidity problem within the confines of the sales tax system. The only option would seem to be to use the tax system to change the time profile of tax liabilities faced by the consumer. Ways of accomplishing this are discussed in the next section.

As mentioned, rental housing is also taxed on a prepaid basis in the hand of the owner, whether that owner be a firm or a household. In other words, all residential rentals are tax exempt. The purpose of this is to reduce the number of taxpayers who are drawn into the taxpaying sector. Many owners of rental housing are individuals who operate the rental on an unincorporated business basis. By making housing rentals tax exempt, owner occupied and rental housing services are treated on a par. Also, individual owners of rental housing need not be registered in the tax system. This has administrative advantages, but it implies that the value added at the renting stage in untaxed, and that the tax on rental housing is effectively prepaid even though it would be feasible to tax it on the same basis as other rentals. It also means that those firms that rent for both residential and non-residential purposes face the added complexity of having to account separately for inputs into each activity. An alternative would be to exempt rental housing provided by individuals, but include it for that provided by taxable firms. This would ensure that the value added of the

latter was included in the tax base on a par with non-residential rentals, and would also avoid the liquidity problems of having to pay the tax up front on rental housing (provided input tax credits were fully refundable). It would also ensure the proper treatment of tax changes and changes in the value of rental services for that segment of the house rental market. But it would favour rental housing provided by non-taxed individuals over that provided by taxpaying firms. Thus, there are both advantages and disadvantages to including rental housing provided by taxpaying firms in the tax base.

Avoiding the windfall gain on the stock of old housing would not be a simple matter. Some ways of proceeding are discussed in the next section. Suffice it to say for now that, to do it properly, it is not a simple matter of simply subjecting the old housing stock to the new tax. It the new tax is replacing one or more tax sources that have already subjected housing to a prepaid tax, as is the case in Canada under both the FST and under personal taxation, the additional tax levied on the stock should only include the implicit increase in the tax on housing. If one accepts the estimates of Kuo, McGirr and Poddar [1988] as discussed earlier, housing may already be taxed close to the average of all consumer goods. In this case, it would be much more appropriate to exclude the stock of old housing from the tax base than to try to impose the new tax on it. Note that this problem is a transitional rather than a lasting one.

The exclusion of used housing is also presumably for administrative reasons. It would be feasible to treat housing as other used goods are treated. When they are brought into the tax system, the taxed firm which buys them from the household for resale is given a notional credit for taxes paid on their behalf. Because of its durability, there are certain complications involved with this procedure for housing. The housing may not have been taxed earlier at all if it already existed when the tax was introduced. Or, if it was taxed, it may

have been taxed at much different rates than now exist. The house may also have had some improvements or maintenance performed which was taxed at yet different rates. In principle, it would be possible for taxpayers to keep invoices for these transaction. However, since many house owners are individuals, this requires bringing them into the net of the tax administration. At best, notional values for taxes on inputs could be used, but they may be very imperfect. Again, it would be possible to treat used houses sold by taxpayers differently from those by non-taxpayers.

On balance, there are several ways in which the tax treatment of housing could be different from those in the White Paper. The details of these alternative ways are discussed more fully in the next section. Before turning to that, one other general question might be raised and that is whether housing should be taxed in the first place. It is conceivable to treat housing as a tax-free good; that is, to zero rate it. This, too, would involve some administrative complications. One way to accomplish it would be to leave rentals and second hand sales tax exempt, and to zero rate the sale of all new housing, improvements and maintenance. Presumably the argument for doing so would be an equity one. Housing might be viewed as a necessity good, or even a merit good, alongside food, clothing, etc. There are, however, several concerns about this. For one, housing is a significant component of household budgets. Removing it from the tax base would involve increasing the rate of tax considerably. It would also involve imposing a significant distortion on the market economy in favour of residential housing at the expense of all other goods. Finally, as the White Paper points out, the equity argument may not be very compelling given that the personal rate structure can be varied to attain virtually any desired degree of tax progressivity by income group. This includes both the use of credits and exemptions as well as changes in the structure of statutory tax rates themselves.

VII. Alternatives to the White Paper Proposals.

The Federal Government proposes to tax housing according to what might be called the "Continental" option. That is, it proposes to tax the services of new housing fully on a "prepaid" basis by taxing all the components that go into the value of a new home. This includes the value of the land, construction, materials and real estate services. There is no attempt to tax the services of housing itself since market and imputed rents are exempt. This means that the services of existing houses will be untaxed.

Despite the similarity of these proposals to the those that apply under European VAT, it should be stressed that, as noted in part III, many European countries have other tax measures that mitigate the difference between the tax treatment of new and existing housing. In England, new housing construction is zero-rated which essentially eliminates the tax on all housing[7]. In some other countries, lower rates and/or the exclusion of the land component of the value of a house reduces the effective tax rate on new housing.

In many countries, there are attempts to tax the services of existing housing through other, highly imperfect, means. For one thing, imputed rents are included under the income tax in several countries. This applies equally to both old and new housing, however, so new housing is still differentially taxed because it is also subject to the VAT. The existence of income taxes on the imputed rents reduces the impact of the redistribution of wealth towards existing homeowners when the VAT on new housing is introduced. Imputed rent is usually calculated as some fraction of the market value of the house. Thus when the value of

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[7]This is not quite the case because, as mentioned in part III, maintenance and now improvements are taxed under the U.K. VAT.

existing housing rises because of the VAT on new housing, imputed rents will rise and some of the increase will go to the government as increased income taxes.

A second and more important method of taxing the services of existing housing in Europe is the substantial real estate transfer taxes that are applied to sales of existing houses in some countries. These taxes do not usually apply, at least until after a certain time period, to houses already taxed under the VAT. Therefore they represent an ad hoc attempt to eliminate the discriminatory treatment of old and new housing under the "Continental" option. The White Paper does not propose to tax the services of existing housing while the value of new housing will be fully taxed under the proposals. Therefore, henceforth, we will refer to the taxation of new housing alone as the "White Paper" option.

There are six viable options available to the federal government with respect to taxing residential housing under a multi-stage sales tax. The first is the "White Paper" option. The second is to make residential housing a "tax free" supply which is similar to the zero-rate method used in the U.K. The third is the "status quo" option which attempts to maintain the existing sales tax treatment of housing by taxing only the materials used in construction. The fourth is to follow the practice of several European countries and apply the sales tax only to the structure component and exclude the land component of the value of a house. The fifth we call the modified Conrad S-tax option which attempts to bring the services of existing housing into the tax base in a manner which is more efficient than the real-estate transfer taxes utilized in Europe.

The above options, to the extent that they tax any component of housing, do so on a "prepaid" basis that taxes the value of the property rather than the rental services it delivers. The difficulties with taxing the imputed rents of owner-occupiers, the administrative and

compliance costs of including landlords in the sales tax system, and the desire to avoid or at least not exacerbate the discriminatory tax treatment of owned and rented housing all argue in favour of this general feature of the options considered. A major disadvantage of the prepaid method is that it requires the payment of taxes on housing services up front at the time the house is purchased. To the extent that only part of this tax can be financed through an increase in mortgage finance, the prepayment may pose serious liquidity problems, especially for low income households with little or no financial wealth. It is possible, however, to tax housing in a way that does not require the prepayment of the entire tax, yet does not involve the difficulties listed above. Essentially this method involves taxing the services of housing under the sales tax in effectively the same way that housing is taxed under the existing personal income tax. The sixth option, which we call the "equity expenditure" option describes this modification which can be applied to either the first or fifth options.

i. The "White Paper" Option.

This option (the National Sales Tax, the invoice method VAT, and the subtraction method GST versions involve essentially the same treatment of housing although the national sales tax option would include housing in the provincial sales tax base and substantially increase the effective sales tax rate) has been discussed at length in part VI. We reiterate the main points only in order to compare it to the other options. The primary advantage of the White Paper option is that it brings housing into the tax base and reduces the tax incentive to consume housing rather than other goods and services. With the broader tax base a lower tax rate can be imposed which reduces the incentive to consume leisure and other non-market goods in preference to market goods. The main disadvantage is that it introduces a capricious and potentially regressive redistribution of wealth in the economy. Although the full value of

new housing is taxed under the proposals, the market price of all housing will rise by a substantial fraction of the additional taxes imposed. This will give a substantial and unwarranted capital gain to the owners of existing housing. In effect wealth will be transferred from those without housing assets (who tend to be poor or less wealthy) to those who have housing assets. It may also exacerbate the liquidity constraints facing the poorer households and make it even more difficult for them to own their own homes.

ii. The Tax-free Supply Option.

This option is, effectively, the zero-rate method used in the U.K. and would eliminate the sales tax on residential housing. Although maintenance and now improvements are taxable in the U.K., it is more consistent and administratively easier to zero rate all residential housing activities. To implement this option, the tax authorities would make the sale of residential housing to a non-taxable entity (the final consumer) a tax free transaction. That is, it would generate no tax liability but the seller would still claim input tax credits against all costs incurred in the sale. Under the subtraction method GST the revenues from the sale would not be added but all costs would be subtracted. Under the invoice method VAT the sale would be zero-rated.

The main advantage of this option is that it is the simplest way to remove housing from the sales tax base if that is so desired. However, as discussed in part I, economic efficiency and, to some degree, horizontal equity require the inclusion of housing in the tax base. While vertical equity may be increased by exclusion, it is better achieved through the personal tax structure. Although there may be non-economic arguments for excluding housing from the tax base, we are not capable of evaluating them.

The tax-free option would not introduce a large degree of administrative complexity although it may open the door for other sectors to demand special treatment. In the U.K. most of the administrative difficulties encountered with zero-rating have been self-inflicted. As mentioned in part III, a distinction was initially drawn between improvements (not taxable) and maintenance (taxable) which generated enormous problems. Now both are taxed although the differential treatment of renovations and new construction invites further problems. It is difficult to understand why the U.K. authorities chose to make this distinction. If the authorities wish to exclude housing from the tax base, the best thing to do is leave all types of residential construction, improvements and maintenance out of the base. The reduction in the revenue lost by keeping housing maintenance expenditures in the base seems hardly worth the administrative costs of doing so. If the tax free option were chosen in Canada, the government would best treat all expenditures on residential housing in the same way.

Note that the tax free option treats housing more favourably than the current treatment under the MST which subjects materials to the sales tax. Thus the tax free option would lower housing prices, ceteris paribus, and create capital losses on existing houses. It would also increase the discriminatory treatment of residential and commercial real estate. There would be incentives to build units for residential use and then convert them to commercial uses unless effective change-in-use rules can be enforced.

iii. <u>The "Status Quo" Option.</u>

In order to maintain the existing system of taxing materials used in construction only, a multi-stage sales tax would have to treat the sale of residential construction to non-taxable persons as a tax free supply as in the tax-free option but not allow input credits for materials used in construction. Thus the costs of building materials would, like wages, not

be deductible under the subtraction-method GST nor would invoice credits for materials be allowed under the VAT. This would be the case even though the sale of the building materials was subject to tax. The sales taxes imposed on all other elements of value added in the construction and sale of the residential dwelling would be credited (invoice method) or deducted (subtraction method).

The main advantage of this option is that by taxing housing under the new multi-stage sales tax effectively in the same way that it is currently treated under the MST, the serious transition problems involving the differential tax treatment of new and old housing would not arise. As far as housing is concerned, the new sales tax base at least would not be narrower than the existing MST unlike the tax-free option. To the extent that the tax authorities wish to maintain the existing preferential taxation of housing services, this option seems to be the best way to do it.

The main disadvantage of this option is that it does not contribute to the government's announced objective of broadening the sales tax base. As a result the efficiency gains from broadening the sales tax base to include housing services would not be achieved and a higher tax rate would be required to collect the same amount of revenue in comparison to the White Paper option. In addition, administrative and compliance costs would be slightly increased.

iv. <u>The Land Exclusion Option.</u>

We discuss this option mainly because some European countries use it and because there is some conceptual controversy over the inclusion of land in a VAT since the value of unimproved land has no value-added. Under the White Paper proposals, the value of the unimproved land is included along with land improvements, building materials, construction

costs and realtor services because the sale of unimproved (say, undivided) land is exempt. That is, the seller of the land does not pay tax on the proceeds of the sale nor does the buyer, say a developer, receive an input tax credit. The value of the land is included in the final price of the house, however, which is subject to tax when sold.

One could exclude land by allowing the cost of unimproved land obtained by the taxable developer to be deductible (or by allowing a notional input credit) while leaving the sale of land exempt. However, where the unimproved land is already owned by the developer, the price of the final house sale would have to be allocated between land (tax free supply) and other (taxable supply). This would pose problems since there would be an incentive to overstate the value of the land component.

While the exclusion of land is sometimes thought to be required by a VAT because there is no value added, this is a legalistic distinction which makes no sense from an economic viewpoint. Although the services of land are not produced, they still provide consumption services. There is no fundamental reason to treat these services any differently than those that are produced. Indeed, it makes economic sense to include them. First of all, the supply of land suitable for residential purposes is largely fixed making it a good thing to tax. Unlike production, there is no activity to distort by taxing unimproved land. Furthermore, the exclusion of land will favour land-intensive forms of residential housing over multiple-unit dwellings.

The main advantage of the land exclusion option is that land with existing structures and land without will be treated the same under the tax. Under the White Paper, the former is exempt in residential use whereas the latter will be taxed to the extent it is subsequently developed for a taxable use. Another advantage is that the exclusion of land would reduce

the effective tax rate on a new house, although the base would still be broader than the existing treatment of taxing building materials only. However, it is unlikely that this would have a significant effect on the price of the final house. Because residential land is largely fixed in supply, the tax on the land component will most likely be shifted back to the land owner.

For these reasons we see little merit in this option. It will not serve the efficiency and equity objectives of the White Paper better than the White Paper option, nor will it contribute significantly to making housing more affordable. Although the sales tax base is broadened, there will probably be unavoidable administrative difficulties associated with the differential treatment of land and improvements under the sales tax.

v. The Modified "Conrad" Option.

We consider here a variant of an option proposed by Conrad [1987] which brings the services of existing houses into the tax base when they are sold by the existing owners. Conrad's proposal is intended as a substitute for the real estate transfer taxes applied to sales of existing houses in some European countries. These European taxes are turnover taxes which apply every time the property is sold with no credits for previous taxes. Thus there is serious tax cascading. Under the Conrad option, existing residential housing is taxed only once when it is first sold and no input tax credit is permitted to a taxable buyer. The property is then designated "tax-paid" and in all future transactions an input tax credit is permitted. If a piece of tax-paid real estate is sold by a non-taxpayer to another non-taxpayer, the taxes are collected from the seller and given to the buyer.

We propose a modified version of this option under which the first sale of existing residential housing is treated as a taxable supply. All subsequent sales between non-taxpayers is exempt. As under the Conrad option, this requires all existing property to be designated as "tax-unpaid" until it is sold for the first time. The first sale of the property is treated as a taxable supply but no input tax credit or deduction is permitted unless the property is purchased by a taxable firm. Once the property is designated tax-paid, all sales to non-taxable persons are then tax exempt. If a tax-paid property is sold from a non-taxable to a taxable person, a notional tax credit is allowed. This is the same procedure that is to be allowed under the White Paper option upon the acquisition of a dwelling for the purpose of renovation and resale by a taxable person (and, presumably, if a residence is purchased and converted to commercial use). Under the White Paper option, the notional input tax credit is allowed on all such acquisitions while under the modified Conrad option it is allowed only on tax-paid property.

The main advantage of this option is that eliminates the unwarranted capital gain to the owners of existing housing (and the consequent undesirable transfer from those without housing assets to those with) that occurs under the White Paper option. This eliminates what is perhaps the most negative feature of the White Paper option. It may, however, cause a capital loss on existing housing to the extent that the tax is shifted backward rather than forward. It also broadens the tax base to include the services of existing residential housing, albeit only as the existing residences are sold. Although this has no direct efficiency effects because the tax on existing housing is a "lump-sum" tax, it broadens the tax base and allows the sales tax to collect the same tax revenue with a lower rate. This has a favourable efficiency effect because a lower rate tax distorts the choice between market and non-market goods to a lesser degree.

The main disadvantage of the proposal is the administrative and compliance costs. Primarily this consists of the need to designate property as tax-paid or tax-unpaid. This does not seem inordinately difficult to administer because the status of the property can be recorded on the deed or other legal document that is attached to the real estate of non-taxable persons.

A major concern is the question of how to avoid bringing all owners of residential property into the tax system. This does not seem to be a problem because most existing property is transacted through real estate agents who are in the tax system. The sale value of all tax-unpaid property by a real estate agent is added to his taxable supply with no input credit or deduction for the amount paid to the existing homeowner. This of course would encourage more self-supply by owners of residential property who will try to sell it privately. Two recourses are available to the tax authorities. First, they can require that anyone selling tax-unpaid real estate must register as a taxable person. Second, and simpler perhaps, they can impose an equal rate stamp duty on the processing of legal documents attached to tax-unpaid real estate.

Another difficulty is the fact that there may be some degree of tax cascading because the materials in existing housing have already been subject to the MST. The simplest way to avoid this problem is to subject existing tax-unpaid property to a lower tax rate that that applied to new housing. For example, if the general rate is 8%, the first sale of existing housing could be taxed at 5%. The 3% difference will compensate for the tax that has already been paid on on the materials in the existing housing. Note that this would only be possible under the invoice VAT method because multiple rates are too difficult to implement under the subtraction method GST.

One difficulty with the Conrad option that would be difficult to overcome is that it causes a "lock-in" effect. Since the sales tax on existing property would not be paid until and unless it is sold, there is an incentive for existing owners to hold onto their tax-unpaid housing. For example, a person who sold her tax-unpaid house and purchased it back or purchased an equivalent house would incur the tax on the value of the house. For this reason a homeowner may hold on to a tax-unpaid house even if an otherwise desirable real estate exchange were possible.

vi. The Equity Expenditure Option.

As mentioned in Section II, owner-occupied housing is effectively taxed on a consumption tax basis under the existing personal income tax in Canada because the implicit return to an owner-occupied housing asset, the imputed rent, is not subject to income tax unlike the pecuniary return to a stock or bond. Unlike the proposed sales tax treatment, however, the consumption tax on housing services is not collected up front. Rather, the household's income, which is then used to acquire equity or pay mortgage interest, is taxed as it is earned. Under the proposed sales tax treatment it is the purchase of the house, rather than the earnings used to acquire equity or pay mortgage interest, that attracts the tax liability. In point of fact, the two methods are equivalent except for the timing of the tax payments (ignoring the fact that under the personal income tax, the tax rate depends on the household's income).

The equity expenditure option is a method of duplicating the consumption tax treatment of housing that exists under the personal income tax for the sales tax system. In essence, it would involve giving an input tax credit to the purchaser of a house that has been subject to the sales tax for that part of the value of the house which is mortgage financed. Therafter

all payments against the mortgage, both principal and interest, are subject to the sales tax. Thus the sales tax on the services of the house is paid as the owner pays for the house through principal and interest payments rather than at the time the house is purchased. Some simple calculations show that the present value of the taxes paid in this case is the same as that prepaid under the White Paper option or the Conrad option.

The difficulty with this option is the problem of implementing it without bringing the home purchaser into the tax system. This can be accomplished by taxing financial institutions in a particular way, at least as far as mortgage transactions are involved. The White Paper proposes to bring financial firms into the sales tax system, but on an accrual basis. A simpler alternative is to tax financial firms on a cash flow basis. Under a cash flow system, all cash receipts by the financial firm, for example payments of interest and principal on outstanding loans including mortgages, are subject to the tax while all cash disbursements, for example the funds loaned out, are deducted from the tax base. In this way, the sales tax would end up being imposed on "equity expenditures" of the home buyer.

For example, suppose a house is purchased for 108 thousand dollars inclusive of an 8% sales tax and the purchaser takes out a mortgage of 90 thousand dollars. The mortgage bank will deduct this disbursement and get 8 per cent, or 7.2 thousand dollars, as a tax credit. At this point, a sales tax of .8 thousand dollars has been paid on net, which is equal to 8 per cent of the value of equity acquired (equal to 100 minus 90 thousand dollars). For simplicity assume that the mortgage principal is never paid off and the interest rate is 10 per cent per annum. The homeowner makes mortgage payments equal to 9 thousand dollars per annum and the mortgage bank pays 8 per cent, or .72 thousand dollars, in sales tax per year. The present value of .72 thousand dollars in perpetuity at 10% is 7.2 thousand dollars yielding a total present value of tax payments of 8 thousand dollars or 8 per cent.

This is the same amount that would be collected under the prepaid system. However, it places less demands on the financial system in that funds do not have to be borrowed to prepay the taxes at the time of the house purchase. (These funds would ultimately come out of private capital formation under the prepaid method just as if the government ran a deficit.) Because the mortgage firm will get a tax credit for mortgage funds it disburses, it will be willing to increase the mortgage to cover that part of the increase in the mortgaged cost of the house that results from the sales tax applied on the value added in its construction and sale. The government receives, and the home purchaser pays, the bulk of the sales tax over time as the mortgage is amortized.

A major difficulty with this option is that the government would have to treat financial firms differently. In particular, a cash flow method rather than an accrual method, as proposed in the White Paper, would be needed. While the treatment of financial institutions under the sales tax lies outside the terms of reference of this study, we believe compelling arguments can be made for taxing these institutions on a cash flow basis. The fact that such a method can alleviate the potential liquidity problems associated with the proposed treatment of housing is just one of the benefits of this method. Note that this financial treatment could apply under either the the White Paper or the Conrad type options.

Alternatively, the government could use the personal tax system to implement the option at the level of the household. In this case, a household would be granted a tax credit for funds borrowed at the existing sales tax rate applying to housing. He would then be required to pay an additional income tax at the at the sales tax rate on funds used to make mortgage payments. This may pose serious compliance problems.

We conclude with a summary comparison of the White Paper option and the six alternatives considered in this section in terms of the criteria of economic growth and efficiency, horizontal and vertical equity, administrative simplicity, and political practicality.

a) Economic growth and efficiency. A major reason for including housing services in the sales tax base is economic efficiency. To exclude housing services would favour their consumption relative to other goods. This is magnified by the fact that, with a narrower sales tax base, a higher tax rate would be required to obtain a given level of revenues. As a result, the quantity demanded of housing would be greater if it is excluded from the tax base implying that a larger fraction of saving would be needed finance residential construction and maintenance. This saving would be unavailable for the financing business investment and the productivity of Canadian business enterprises would be reduced as a consequence.

With respect to this criterion, the narrower tax bases such as the tax-free supply option, the "status quo" option and the land exclusion option are inferior because they exclude some or all of housing services from the tax base thus encouraging greater consumption of housing services and implying a higher sales tax rate. A broader base, such as the modified "Conrad" option would yield a smaller efficiency gain over the White Paper option because the services from existing housing which are taxed under this option are fixed in supply. Thus the extra component of the base in this option is of the form of a "lump-sum" tax. However, the broader base would allow a lower rate which allows a small efficiency gain. Against this must be weighed the possible efficiency cost of the "lock-in" effect inherent in this option.

The use of the equity expenditure option on, say, the White Paper tax base may have some effects on growth. Under the White Paper option, the tax on a new house must be paid up front. Thus, mortgages will be higher and additional saving will be absorbed for the

purpose of paying these taxes. In comparison, the equity expenditure option allows the taxes to be paid more or less as the housing services are consumed. To the extent that the government spends the "up front" taxes collected under the White Paper option on current consumption goods, and to the extent that these taxes come out of private saving rather than private consumption, there will be less funds available for investment. For this reason, the equity expenditure option may be more conducive to growth.

b) Horizontal and Vertical Equity. It is probable that, ceteris paribus, the inclusion of housing services in the sales tax base reduces vertical equity because the share of a household's budget spent on shelter declines with household income. For this reason, options ii), iii) and iv) may increase vertical equity if we assume that the lost revenues are made up in income taxes or higher sales tax rates on other goods which are not biased towards the budgets of lower income households. However, the White Paper makes a compelling argument that such exclusions are in poor way of attaining vertical equity goals because higher income households still account for a larger share of total housing expenditures. A simple housing exclusion gives a large benefit to a rich person who purchases a mansion, for example. For this reason, vertical equity may better be attained through the use of the personal income tax system such as by allowing a refundable, vanishing sales tax credit. Also, some part of the tax on housing may be shifted back to factor owners rather than forward to consumers of housing services. To the extent that factor owners are higher income households, for example land owners, the tax on new housing may be more progressive.

Vertical and Horizontal equity considerations play a large role in the choice between the White Paper option, which excludes the services of existing houses, and the modified Conrad option which includes them. Two otherwise identical households, one who already owns a house and the other who purchases a house after sales tax reform, will be treated differently

under the two options. The White Paper option confers a large capital gain on the former, which is not taxed under the existing income tax system, and a large tax liability on the latter. Thus it is horizontally inequitable. Moreover, it is likely that the new home purchaser is younger and poorer than the home owner so the White Paper also causes a vertical inequity. The Conrad option overcomes these inequities to some degree by taxing the services of new and existing homes equally.

c) Administrative Simplicity. A major advantage of the Whitepaper option is that it is administratively simple. The exclusion of housing services would add administrative complexity, particularly if maintenance or improvements are included in the tax base as in the U.K., or if the land exclusion option is adopted. The "status quo" option would be slightly less complex but more difficult than the White Paper option. Also, the exclusion of existing housing greatly simplifies the taxation of housing services, albeit at the cost of excluding the services of existing houses altogether. While the modified Conrad option would clearly be more complex, it need not be prohibitively so as long as houses are taxed only on first sale and exempt thereafter as long as they stay in the non-taxable sector.

d) Political Practicality. Perhaps a major reason for excluding some housing services, whether it be that of existing housing or the exclusion or preferential treatment of new housing, is political practicality. In this regard, the White Paper option is attractive to politicians in that it would not attract the animosity of an important majority--existing home owners--indeed it would confer on them a tidy tax-free capital gain. New home buyers consitute a minority and a young, politically weak minority at that. In the final analysis, this may decide the choice between the apparantly fairer and more economically efficient modified Conrad plan and the White Paper option.

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Glossary of Technical Terms Used

accrued income: income measured on the basis of when it is earned rather than when payment is actually received.

capitalization: the change in value of an asset to reflect changes in the future stream of after-tax earnings on the asset.

cascading: the multiple taxation of the same commodity, as when taxes are imposed at successive stages of production on the same base.

comprehensive income tax: a tax imposed on income measured on a comprehensive base so as to include accrued earnings from all sources.

consumption tax: a tax levied on all final consumption; it may be levied on transactions (e.g., a general sales tax) or on persons (e.g., a personal consumption tax).

destination basis: a tax levied by a jurisdiction on commodities which are consumed in the jurisdiction or on income which accrues to persons residing in the jurisdiction.

distortion: anything which makes the price paid by demanders on a market differ from the price received by suppliers (e.g., a tax)

equilibrium: A situation in which the price on a market is such that demand equals supply; on the housing market, stock equilibrium exists when the price of housing is such as to equate the demand for the existing stock of housing and the given supply; similarly, a flow equilibrium is when the price of housing equates the flow of current new housing onto the market with the demand for the additional housing.

equity ownership in housing: that part of the value of a house which is owned outright by a person rather than being financed by, say, a mortgage.

human capital investment: the cost of acquiring skills which are valued in the labour market (e.g., education, on-job training).

imputed rent: the rental value of a the housing services accruing to owner-occupiers.

indexing for inflation: including in the tax base only the real rate of return of assets rather than the nominal rate of return, which includes some compensation for the fall in the real value of the asset due to inflation.

integration: giving shareholders credit for taxes paid on their equity income at the corpoate level.

liquidity: funds that can be obtained at relatively short notice; a person is said to be liquidity-constrained if such funds are not available.

neutrality: a property of a tax which means that the tax does not affect the behaviour of the taxpayer on whom it is imposed.

origin basis: a tax levied by a jurisdiction on income generated or commodities produced in that jurisdiction.

put-in-use rule: the tax rule which allows capital cost allowance deductions to be taken only after the asset is actually put to use earning income.

registered asset: an asset which is sheltered from tax by allowing the saving in an asset and the capital income accruing on it to be tax-deductible, but the running down of the principle and accumulated capital income to be taxable in full.

rent: in the economic sense, rent is the earnings generated by an asset which are over and above the full costs of producing the earnings.

self-supply: the production of a good or service for oneself rather than acquiring it through the market.

shifting of tax: the process by which the person liable for a tax is able to recover part of the cost of the tax by selling at a higher price (forward shifting) or purchasing at a lower price (backward shifting).

speculative demand: the purchase of an item whose future price is uncertain to be resold at a later date when the price has changed, with the hope of making a profit.

stock-flow dynamics: in the housing market, the process by which changes in the flow of new housing move the housing market to a stock equilibrium.

tax-exempt supplies: in a multi-stage sales tax system, commodities for which the selling price is not taxed, and credit is not given for taxes having been paid at an earlier stage; only the value added at the tax-exempt stage will be untaxed.

tax-free supplies: in a multi-stage sales tax system, commodities for which the selling price is untaxed and full credits are given for taxes paid at earlier stages; the full selling price of the commodity is effectively untaxed.

tax prepaid asset: an asset for which a tax was paid when it was first acquired, and for which no further taxes are paid, including taxes on asset income.

tenure choice: the decision of a person to own housing or to rent it.

value added: the increase in value to goods in process at a particular stage of production by the use of labour and capital services.

vertical integration: the expansion of a firm into more than one stage of production for a product.

windfall gain: the increase in the value of an asset which is unexpected by the owner of the asset; correspondingly, a windfall loss is the unexpected loss in the value of an asset.

Appendix

STUDY OF THE TAXATION OF RESIDENTIAL HOUSING FOR C.M.H.C.

The GST Treatment of Housing and Rentals

Q1. Please confirm the following. New housing (including attached land) is fully taxed under the New Zealand G.S.T. (current rate= 12.5%). Rentals and existing houses are exempt.

Residential Property:

As most residential property is owner-occupied in New Zealand, a large proportion of sales of residential property are made directly by and to private owners not registered for GST and hence are not subject to GST. The margins of real estate brokers are taxable under GST at the rate of 10%, as is the construction and sale of new buildings (including land) by registered traders.

Residential Rents:

Neither the imputed rental from owner-occupation nor actual rents paid by tenants are subject to GST.

Q2. Are there any real estate transfer taxes or stamp dutieson the sale of existing residential properties? If so, at what rate,and are properties recently subject to the G.S.T. exempt? Are there any cbanges in these taxes pending?

There are no real estate transfer taxes and stamp duty on the conveyance and lease of residential properties has been abolished with effect from March 17, 1988.

Q3. Does New Zealand have a net wealth tax? If so, how is residential real estate included and at what rate?

There are no taxes on net wealth per se, although a land tax and estate tax and gift duties are levied by the central government and property taxes are levied by local authorities. (There are no provincial or state governments in New England.)

Land tax is applied, at the rate of 2 per cent of unimproved land value as revalued by a government valuation agency every 3 to 5 years. There is a minimum land value threshold of $175,000 below which no tax is assessable. This exemption abates at $1 for $1 and is, thus, completely abated at $350,000. Certain categories of land ownership - including land used for primary production, residential or recreational use - are exempt. Estate duty is applied at a rate of 40 percent on the assessable net value of a deceased person's estate in excess of $450,000. Gift duty is applied on a scale between 5 and 25 per cent on the total of assessable gifts by any person in excess of $27,000 in any 12-month period.

Q4. Are "local body" taxes based on real estate values? Is market value used and what is the range (high-low) of tax rates? Please confirm that local body taxes are subject to the G.S.T.

Property taxes are the single most important source of local authority finance. They are levied, at the discretion of the local body, on either land value, capital value (land plus improvements) or annual value (the rental value of the property let at a market rate).

Local authority taxes are deemed to be payments for goods and services supplied by the local body, and accordingly are subject to GST.

Q5. Are imputed rents on owner-occupied housing (that is, the rent a home-owner implicitly pays himself) subject to income tax in New Zealand as in some European countries? If so, please give details.

No.

Q6. Are there any deductions or credits for the expenses of maintaining an owner-occupied home (specifically mortgage interest, property (local body) taxes, depreciation and maintenance expenses) in the New Zealand income tax code? If so, are there any limitations?

No. Two such provisions - both of restricted in value - were formerly available. A minor rebate (or tax credit) for local authority rates was removed from April 1, 1985, and a rebate for interest payments (subject to a limit) for the first 5 years of first home mortgages was withdrawn for purchases after November 8, 1984 (and has now largely phased out).

Q7. Are there any special tax deductions against the rental income of landlords (e.g., accelerated depreciation)?

The only special provisions are subject to termination. In 1983, an accelerated depreciation allowance (at double the ordinary depreciation rates) for newly constructured private rental housing was introduced for the first 5 years of units first available for occupation on or before March 31, 1987. This has not been extended. Secondly, a first-year depreciation allowance for employee accomodation was repealed with effect from April 1, 1988 except for qualifying assets for which the contract was let before that date and which first produce assessable income before April 1, 1990.

Q8. Please confirm that there is no tax on capital gains in New Zealand. If this is incorrect, are there exemptions for residential property?

There is no explicit capital gains tax in New Zealand at present though some gains are taxed under the Income Tax Act 1976 (see attached excerpt from "The Taxation of Capital Gains in New Zealand" by A. Alston, Institute of Policy Studies, 1986). The Government has signalled its intention to intensively examine the scope for the introduction of capital gains and/or asset taxes.

Q9. I understand there are provisions to offset the burden of the G.S.T. on the purchasers of new housing. If these are not too complicated, please provide general descriptions.

Provisions were made to offset the burden of GST on the purchasers of new housing - a scheme called "Homestart" was introduced - refer to Appendix I attached for details.